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S. HRG. 98-1170

PROTECTION FOR PURCHASERS OF FARM PRODUCTS

HEARING

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION

OF THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 2190

A BILL TO AMEND THE AGRICULTURE AND FOOD ACT OF 1981 TO PROVIDE PROTECTION FOR AGRICULTURAL PURCHASERS OF FARM PRODUCTS

SEPTEMBER 26, 1984

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PROTECTION FOR PURCHASERS OF FARM PRODUCTS

WEDNESDAY, SEPTEMBER 26, 1984

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 328–A, Russell Senate Office Building, Hon. Walter D. Huddleston presiding.

Present: Senator Huddleston.

STATEMENT OF HON. WALTER D. HUDDLESTON, A U.S. SENATOR FROM KENTUCKY

Senator HUDDLESTON. The subcommittee will come to order.

I want to thank all of today's witnesses for coming.

Today's hearing is for the purpose of receiving testimony on S. 2190, legislation I introduced that is designed to provide protection for purchasers of farm products. I am pleased that the Subcommittee on Agricultural Research and General Legislation will have the benefit of testimony from a wide variety of groups that are interested in S. 2190.

In the interest of time, I would appreciate witnesses keeping their oral testimony to 5 minutes. Your full written statements will be included in the hearing record.

I realize that S. 2190 has its opponents as well as supporters. In that regard, I want to emphasize that I look forward to hearing the arguments of both the proponents and opponents of S. 2190. One reason I introduced the legislation was to begin the process of resolving what has become a serious problem. I believe it is important that the various interested parties try to work together on finding a way in which the problem can be resolved uniformly. The reason for having a Uniform Commercial Code is to provide for a more efficient, uniform method of moving goods in commerce.

One issue I hope will be covered today is this—should we wait for each State to determine whether or not and how it will amend its commercial code, or is the problem more appropriately one that should be handled by Congress.

Another issue is the form remedial legislation should take. My own State of Kentucky has amended its commercial code, and it is my understanding that producers and lenders have not encountered any great difficulties as a result of the change. While the

Kentucky Bankers Association has expressed opposition to enactment of S. 2190, they have suggested that Kentucky's new law might be the model for a compromise solution.

Also, I understand that some agricultural lending institutions have concerns about the effects that legislation such as S. 2190 would have on their ability to extend credit to new borrowers, sharecroppers, or farmers whose farmland and equipment are already highly encumbered. Their concerns are of concern to me, too. That is why I believe it is important for us to explore all avenues and would urge all concerned parties to work together so that we can have a consensus, if at all possible, on a solution to this problem.

In addition to hearing testimony on the pros and cons of S. 2190, as introduced, I look forward to testimony which might provide alternative solutions.

Before we begin the testimony, I would like to insert in the hearing record a statement by Willis G. Moremen, executive vice president, Kentucky Bankers Association, in opposition to S. 2190. Also, I would like to insert in the record a copy of a letter to the committee from Secretary Block setting out the Agriculture Department's arguments against S. 2190.[1]

At this time, I call the first panel of witnesses. Ray Mackey, president, Kentucky Farm Bureau Federation, representing the American Farm Bureau Federation; Granville Tilghman, chairman, country elevator committee, National Grain and Feed Association; Gail Tritle, president and general manager, Central Livestock Association, Inc., south St. Paul, MN, and Prof. Ralph Rohner, Catholic University of America, representing the American Meat Institute.

We will just begin with the statements in the order that I called. Mr. Mackey.

STATEMENT OF RAY MACKEY, PRESIDENT, KENTUCKY FARM BUREAU FEDERATION, REPRESENTING THE AMERICAN FARM BUREAU FEDERATION

Mr. MACKEY. Thank you. Thank you, Mr. Chairman, members of the committee, ladies and gentlemen.

My name is Ray Mackey, president of the Kentucky Farm Bureau Federation. I am a grain, livestock, and tobacco farmer from Elizabethtown, KY. I am also a member of the American Farm Bureau Federation Board of Directors.

I would like to submit a detailed statement for the record and give a brief summary to the committee at this time.

Senator HUDDLESTON. The statement will be included in the record in its entirety.[2]

Mr. MACKEY. For a number of years the livestock and grain industries have been plagued with a difficult situation which adversely affects companies that handle sales transactions for farmers, ranchers, and others. The problem is created by a small minority of producers who illegally sell livestock, grain, or other commodities

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[1] See p. 43 for the letter from Mr. Moremen and p. 168 for the letter from Secretary Block regarding S. 2190.

[2] See p. 45 for the prepared statement of Mr. Mackey.

which have an outstanding lien, and without paying the security holder the funds are converted to other uses. Third party buyers without actual knowledge of the reported liens are liable to the security party for the value of the commodity, and incur a loss equal to that value.

As a result, the injured third party pays for a commodity twice, once to the seller and once to the bank as payment for the seller's loan.

We are concerned about this situation for three reasons:

First, it poses an undue financial hardship on markets to which producers sell their commodities. We are interested in any problem which reduces the economic viability of agricultural markets.

Second, as the problem continues to grow, it is adversely affecting individual farmers as well as the markets to whom farmers sell their products. Farmers buy products such as feeder cattle and pigs, and breeding stock from other producers. Under the current lien laws, farmer-buyers are required to make double payments when loans are not repaid to security holders.

Third, the current situation is inequitable. Section 9–307 of the Uniform Commercial Code states:

> A buyer in the ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfect and even though the buyer knows of its existence.

This section of the code, therefore, treats agricultural producers differently than any other businessmen and means that the purchaser of a farmer's grain or livestock is liable to pay for commodities twice when the producer fails to repay the lien holder for the mortgaged commodities.

To avoid the double payment possibility, the buyer is expected to conduct a title search on the hundreds of sales transactions conducted daily. The title could be recorded in a county that is not even in the same State as the sale. The sale could also occur in the evening or on the weekend when county offices are not open.

It is unreasonable for the livestock market or grain elevator to become a credit supervisor for a lending institution. In effect, the buyer of farm products becomes the involuntary guarantor of a loan about which he knew nothing, in which he had no input as to the advisability of the loan or the limit of the credit granted, and for which he receives no compensation in the form of interest to cover risk exposure and jeopardy he has involuntarily and unknowingly assumed.

The inequity is especially apparent for the livestock market which does not have the protection of other buyers in commerce because of the lien laws, but is subject to the prompt payment requirements of section 201.43 of the Packers and Stockyards Act.

Lenders argue that the cost of credit will increase and the availability of credit will decrease if the exemption is eliminated. This hypothetical argument used by the lenders is without merit. If our leading State in agricultural production is an example of what will happen to agricultural credit upon removal of the exemption, then this is clearly not the case.

In 1976, California eliminated the exemption and non-real-estate farm loans increased in every year except one. The increase was at

a more rapid rate than the national average. The harm presently being suffered by farmers far outweighs a speculative or unconfirmed concern that the elimination of the exemption might adversely affect farm credit.

Based on these arguments, we believe that agricultural lenders are opposed to elimination of the exemption because it lowers the risk on agricultural loans and allows less stringent loan supervision.

It is important to note that significant quantities of grain and livestock are marketed across State lines. When encouraging Congress to pass grain elevator bankruptcy legislation, we argued that uniform State laws were necessary to facilitate agricultural trade. The same point is valid in this issue.

For these reasons we feel that a State solution to the problem is not appropriate. Senator Huddleston's bill, S. 2190, enables buyers of farm products to take title free of third-party security interest. This bill, with a minor amendment to protect livestock agents and auction markets is the proper legislative solution.

In Kentucky, we have taken action to partly resolve the problem that develops when mortgaged agricultural commodities are sold. For example, Kentucky farmers have experienced the misfortune of losing a great deal of money from grain elevators and stockyard bankruptcies.

Often these bankruptcies were brought about because the marketplace was forced to pay twice for the same commodity which had been sold illegally.

In 1982, we amended our State law by giving the same protection to licensed grain and livestock markets.

Kentucky's law has worked very well, and I might add that agricultural credit is still available and our lending institutions have not fled the State as many might have thought. Unless Congress takes action to solve the problem, many States will follow the ways of Kentucky, by adopting a wide range of legislative solutions. This action could possibly bring about additional problems, because the various State laws governing commerce will no longer be in place.

Mr. Chairman, we appreciate the interest and support this subcommittee has shown in the mortgaged agricultural commodity problem, and suggests that S. 2190, with a minor amendment, be the proper solution.

Senator HUDDLESTON. Thank you, Mr. Mackey.

We will have a question or two for you after we hear from the other members.

Mr. Tilghman.

STATEMENT OF GRANVILLE TILGHMAN, CHAIRMAN, COUNTRY ELEVATOR COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION

Mr. TILGHMAN. Mr. Chairman and members of the subcommittee:

My name is Granville Tilghman. I am president of General Utility Co., a country elevator in Dunn, NC. I am chairman of the

Country Elevator Committee of the National Grain and Feed Association, which I represent in my appearance today.[1]

The National Grain and Feed Association is a voluntary association of grain and feed firms ranging in size from the smallest country elevator to the largest grain and feed complex, and includes merchandisers, processors, warehousemen, and exporters of a wide spectrum of grains and feeds.

I am pleased to have the opportunity to testify on the problems caused by the purchase of mortgaged agricultural commodities. We commend the chairman and members of this subcommittee for providing this forum to give national attention to this problem and to seek industry input toward feasible and reasonable solutions.

The so-called "farm products exception" of section 9-307 of the UCC treats agricultural producers differently than all other businessmen. Unlike any other business transaction, this means that a purchaser of grain or livestock from a producer is liable to the secured lender in the event that the producer fails to pay his debt.

The problem with this exception for agricultural commodities that confronts grain buyers is twofold: One, the grain buyer is faced with the risk of substantial loss if the producer defaults on his loan, and two, the grain buyer must invest time and administrative expense in searching county clerks' offices for the existence of liens on agricultural commodities he intends to purchase.

Concerning the extent of risk of financial loss, we are not aware of any data that shows the total amount of losses grain buyers in the United States have incurred in recent years. But reported losses by some individual grain elevators demonstrate the potential catastrophic consequences of the grain buyer's liability to the lender.

In 1982, nine elevators in the State of Ohio reported total losses of $204,000 for an average loss of more than $22,000 per facility.

Indiana had one case in which an elevator lost $125,000 to a farm lender.

In Illinois, one elevator reported a single loss of $57,000 in 1981, and currently there are three cases in Illinois courts, each of which could result in a loss exceeding $100,000 to individual companies.

The second problem with mortgaged agricultural commodities under the UCC of most States is the burden it places on grain buyers to conduct lien searches. In most States, that involves checking with local lenders to determine if a lien has been filed on a farmer's crop. Under the best of circumstances, this is a laborious, time-consuming, and expensive process. One elevator operator estimated his company's manpower and administrative costs for lien searches at $25,000 a year. Because a single farmer's operations may span over several counties a search must be completed in every county where the farmer has growing crops. Even if such checks are made, there is no ironclad guarantee that an existing lien will be discovered.

There have been a variety of legislative proposals in various grain-producing States to alleviate the problem of buying mortgaged grain. As of September 1984, a total of 15 grain-producing

[1] See p. 159 for the prepared statement of Mr. Tilghman.

States had enacted legislation amending the UCC to address this problem. This patchwork of inconsistent State laws obstructs the orderly marketing of grain.

At its meeting on September 11–12, the board of directors after a thorough discussion of the issue, formulated and adopted the following position to address the mortgaged commodities problem:

It is the position of the National Grain and Feed Association that Congress should enact Federal preemptive legislation requiring that any farmer who executes a mortgage on grain or livestock notify the mortgage holder of the names and addresses of other persons to whom he will market those products. The mortgage holder, if he wishes to have a joint check drawn, shall be required to notify the potential buyers by certified mail of the existence of the lien. Failure of the mortgage holder to so notify shall release the buyer from liability. Criminal penalties shall be assessed against a producer who sells to a buyer other than those specified in advance to the mortgage holder in the event the loan is not repaid.

The National Grain and Feed Association believes this approach offers the most equitable solution for buyers, lenders, and producers of agriculture commodities for the following reasons:

It relieves the buyer of agricultural commodities from the burden, expense, time and risk involved in conducting lien searches county-by-county. It resolves the most critical problem involved in mortgaged commodities by providing information to the buyer of those commodities on which a lien may exist and relieving the buyer of liability in the event the lender fails to notify potential buyers of the existence of the lien.

It recognizes that country elevators and feed manufacturers frequently are placed in the role of lender when financing producers' crops, farm supplies, feed and livestock. It provides equity to those needing some limited security provided by liens issued for feed, fertilizer and other farm supplies.

It is more feasible to implement than a national central filing system, as there are substantial "start-up" costs and delays associated with central filing.

As Federal preemptive legislation, it would establish nationwide law that would apply to Federal lending agencies, such as the Farmers Home Administration and the Farm Credit Administration.

Although it is Federal preemptive legislation, its enactment would result in minimal disruption of the laws of existing States that have adopted a similar legislative approach (Illinois, Indiana, Kentucky, Michigan and Ohio).

It provides the most feasible solution because of the initial record of success of similar legislative approaches in several States.

Finally, it is a fair solution to the problem of mortgaged commodities. Under the current UCC in most States, lenders have no responsibility once liens are perfected. This situation is not conducive to sound lending practices. The National Grain and Feed Association's position is fair to all parties involved—the producer, the banker and the commodity buyer—and recognizes that each legitimately should share the responsibility. Under the National Grain and Feed Association's position, the producer is responsible for providing accurate information on potential buyers to his lender. The lender is responsible for ensuring that payments on commodities are properly drafted to all parties having ownership or security interests.

In summary, the present treatment of farm commodities in the UCC is based upon the conditions and structure of agriculture that existed in the early 1950's when the UCC was first drafted.

U.S. agriculture has changed dramatically since that period. The farmer of the 1980's is a commercial businessman, and the law should reflect that reality. The agricultural commodity buyer should not be burdened with sole responsibility for policing the security interests of lenders. Nor should lenders bear the entire risk of default on mortgaged commodities.

In seeking a permanent and equitable solution, producers, lenders, and commodity buyer each must share part of the responsibility. The National Grain and Feed Association believes Federal preemptive legislation to require prior notification of liens obtained on

agricultural commodities and livestock balances the needs of all parties in commercial transactions of mortgaged commodities, and we urge Congress to act on our proposal.

Senator HUDDLESTON. Thank you very much, Mr. Tilghman.

Mr. Tritle.

STATEMENT OF GAIL I. TRITLE, PRESIDENT AND GENERAL MANAGER, CENTRAL LIVESTOCK ASSOCIATION, INC., ST. PAUL, MN

Mr. TRITLE. Mr. Chairman, my name is Gail Tritle, and I am president and general manager of Central Livestock Association, Inc., in south St. Paul, MN. Central Livestock is a cooperatively owned livestock marketing agency serving a six-State area and handling approximately 1,500,000 head of livestock annually for its farmer members.

I appreciate very much the opportunity to appear before this subcommittee. The present situation involving farm product liens is unfair to buyers who, with no practical means of protecting their interest, often must pay for products twice, once at the point of sale and the second time to lien holders, if sales proceeds have been diverted.

Though the proposed legislation—S. 2190—under consideration by this subcommittee would provide relief to buyers, it does not fully address the concern that lenders do need some means by which to enlist the aid of buyers in enforcing security interests in agricultural products.

Various remedies have been legislated at State levels, some more cumbersome than others. All are limited in effectiveness, particularly as applied to the large volume of interstate traffic in agricultural commodities.

In hopes of developing a workable solution with regard to these issues, I would like to recommend the following:

First, a distinction should be drawn between those security interests which have been perfected by filing procedures at the county or State level and those security interests which not only have been perfected but about which information has been communicated directly to buyers.

Second, the compromise should result not only in a more equitable and constructive sharing of responsibility between the buyer and the lender, but should place some of the burden on the producer/borrower who benefits from the participation of buyers and lenders in the agricultural business.

Finally, a solution to the current problem needs to be uniform nationally. Preemptive action at the Federal level would seem to be the only method of achieving standardization.

In my view the following elements should be incorporated into any legislation which would amend the Uniform Commercial Code in its treatment of security interests in agricultural commodity sales:

First, buyers of agricultural products should own such goods free of any security interest, except for liens of which the buyers have received actual written notice within 18 months prior to this sale. The effect of this provision would be that buyers are relieved of responsibility for liens, unless notified directly by the lender or the

borrower. Lenders would have the ability to hold buyers responsible for liens by providing direct written notice of the liens.

Second, to shift a portion of the burden to the borrower, a producer would be required to provide to the buyer a certification of ownership indicating whether or not liens are outstanding against the commodity. False certification would carry criminal penalties. The distinction between felony charges or misdemeanor charges could be drawn according to the size of the transaction and needs further discussion.

Third, the buyer would be required by law to issue a joint check when either the producer or the lender indicates a lien exists on the commodity, unless the lender waives the requirement in writing. The buyer would be relieved of any responsibility for an unknown security interest if the producer certifies there is no interest, even if such certification is false, unless, of course, a lender has provided direct written notice to the buyer of an existing lien.

Such an approach, Mr. Chairman, would have the following advantages:

First, it would relieve buyers of responsibility for unknown security interests;

Second, it would provide lenders with the ability to enlist the aid of buyers in enforcing security interests;

Third, it would shift some burden of responsibility to the borrowers; and

Finally, it would remove competitive disadvantages for the buyers by requiring joint checks to be issued when a security interest is known.

I believe, Mr. Chairman, that a workable compromise can be reached on this issue. Though I, as a buyer of agricultural commodities, agree wholeheartedly with the testimony of fellow buyers concerning the unfairness of the present law, I do share, as a past officer of a commercial bank and currently a director of a commercial bank holding agricultural loans, a concern with the lenders that lenders be provided some means of enlisting the aid of buyers. I further believe the entire system can be strengthened by assigning some of the burden of enforcement of security interests to the borrower. I hope, Mr. Chairman, the subcommittee will give serious consideration to these recommendations. Thank you for the opportunity to express my views on this most difficult problem.

Senator HUDDLESTON. That would mean then that the borrower is playing a more significant role.

Mr. TRITLE. It involves the borrower in a way that I think needs further discussion because——

Senator HUDDLESTON. How would the lender protect his interest?

Mr. TRITLE. Well, the lender—we are suggesting that there really be two ways that the buyer can receive notice. The lender can give notice to the buyer, but also have the borrower provide some form of certificate. It is almost as if there is a dual system, and part of our thinking was that this would involve the borrower in a way that would make him a bit more aware of the security interest he has granted in his commodity. Then there is another concern we thought should be addressed by an element to be incorporated in the legislation, and that is to put some further teeth into a requirement that when a buyer knows of a security interest that he must

by law issue a joint check. Again, this deserves some further discussion, and I don't claim that we have covered every problem associated with it, but it addresses a concern among buyers, that they are at some competitive disadvantage against other buyers, depending on their attitude toward direct notice.

In other words, one buyer receiving direct notice of a security interest writes a joint check, but another buyer will not write a joint check because the farmer-borrower insists that he wants an individual check, and that buyer is willing to take on the risk that he may incur a loss later on.

So there is some perception by buyers that they can be put at a competitive disadvantage against fellow buyers. In our own case we lost some business to other agencies operating in our area. If we receive notice we write a joint check, and we know of agencies that don't do it, and are waiting for the wheels of justice to slowly grind out the claims for second payment. But to summarize, we think the advantages of a compromise approach here would be that you would have relief provided to the buyer. You would provide the lender a way to enlist the aid of the buyer in enforcing his security interest. You would pull the borrower into some accountability, and we believe that that would be constructive, because it would make the borrower a little more aware of the financial nature of the transaction when the lender has provided the money. And, finally, we would like to remove any competitive disadvantages from the borrower.

We do believe that a compromise solution can be developed. We believe there is some piece of legislation not yet drafted, but some piece of legislation that can be supported by both sides of this issue, and we appreciate the opportunity to express our thoughts today.

Senator HUDDLESTON. Thank you very much. We are glad to have your testimony.

Professor Rohner.

STATEMENT OF RALPH J. ROHNER, PROFESSOR OF LAW, REPRESENTING AMERICAN MEAT INSTITUTE

Mr. ROHNER. Thank you, Mr. Chairman.

I am Ralph Rohner, a professor of law at Catholic University, and I have been teaching commercial law about 20 years.

I appear today on behalf of the American Meat Institute, which is the national trade association of red meat packers and processors. With me today is Gary Jay Kushner, who is AMI's vice president and general counsel.

Mr. Chairman, we have a prepared statement, and an extensive attachment to that which we would submit for the record.[1]

Senator HUDDLESTON. It will appear in full in the record.

Mr. ROHNER. I would like to address the three questions that you posed in your opening statement this morning.

As a premise to that we believe that the hearing record on the House side and the hearing record that you already heard this morning, and will hear this morning, makes a compelling case that

[1] See p. 51 for the prepared statement and additional material furnished by Mr. Rohner.

the State law, the Uniform Commercial Code, is simply intolerable for the buyers of agricultural products. We, therefore, enthusiastically support S. 2190, your bill, and we are delighted with the suggestions already proposed this morning about possible alternative ways of attacking the problem. You posed three questions, if my notes are reliable.

Should we wait for the States to act? The answer we submit is, obviously, we cannot. The difficulty arises from the fact that the problem is rooted in the Uniform Commercial Code itself, it is uniformly the law in all but one State, California, that creates the difficulty for buyers of farm products. There is no realistic likelihood in the foreseeable future that the sponsors of the Commercial Code will take steps to revise it and solve this problem.

What you are seeing, of course, is the various States—15 or 16—enacting legislation of their own. So far as I know, no two State legislative efforts are exactly the same, and that creates the crazy quilt pattern that one of the other witnesses referred to which becomes itself an intolerable state of the law for any buyers operating interstate, in regional markets in particular.

There are additional reasons why it would be appropriate for the Congress to act in this area. Of course, it would provide uniformity automatically throughout the States. In the case of meat packers and processors there is an additional reason. There is already extensive Federal regulatory activity in those markets—in particular the Packers and Stockyards Act—and Federal law exacerbates the problem that the Commercial Code creates. Thus, there is not only the reason of diversity of law in the States, but there are substantial Federal interests in the marketing of meat products that justifies Federal action.

I may add in passing that it is not just the fact that some 15 or 16 States have legislated. The courts across the country have been going in all different directions with cases involving claims against farm products, so the problem of inconsistency is complicated by judicial action as well as by legislative action.

Your second question, Mr. Chairman, was about the form that the remedial legislation should take. We, of course, support S. 2190, and believe it would handle the problem cleanly, and with fairness. We believe your bill to be the most effective and realistic approach. At the same time, we are, as I mentioned, encouraged that there are suggestions of other possible ways of approaching the problem. We would be interested in working with any groups to try to work out such a process.

Our cautions, in the regard, would be similar to those of Mr. Tritle. It would not be useful, it seems to us, to generate a law that requires extensive notification if, in fact, such a mechanism amounted to nothing but blizzards of paper that no one paid attention to or that simply did not give usable information.

We were talking earlier this morning about a processor who received a letter from a lender listing 90 producers in the area whose products he was financing. There is some reason to wonder whether a letter listing 90 producers is useful information to a processor who may or may not be dealing with one or more of those producers.

I might suggest, Mr. Chairman, that S. 2190, as written, would give creditors the opportunity to do exactly what the various State notification statutes impose on them now as an obligation. That is, as I understand it, it is entirely possible for a lender under your bill to take steps on his own initiative to identify buyers of his producers' products, to give them advance notification of the existing security interest, and in such a way insure that those buyers will then be responsible for seeing that the proceeds of that sale are properly applied. So I don't see that there is a fundamental difference between the approach of S. 2190 and some of the other suggestions being made.

Lastly, you asked about the possible impact of such legislation as S. 2190 on the availability of financing. It has already been demonstrated through the experience in California that elimination of the farm products exemption from the UCC have created no serious difficulty in the ability of producers to get loans.

We certainly agree with others who have testified that the horror stories about the possible drying up of agricultural credit are just that, horror stories.

There is another side to that and I will conclude on this point. In the testimony on the House side last fall, one of the witnesses who was a livestock processor expressed a concern that it is not just a question of the availability of loans to producers, but also the viability and financial health of the meat processing and packing industries as well. The meat industry is already suffering numerous bankruptcies and the burden of the farm products exception as it now exists, further significantly threatens the financial stability of meat companies. That has its own consequences for their communities as well.

That same witness summarized his point in this way. He said the meat industry is having enough trouble staying alive today "without laboring under the contingent liability of the national farm debt." We believe there is some real basis for concern in that observation.

Mr. Chairman, I will be happy to answer any questions that you may have.

Senator HUDDLESTON. Thank you very much, Professor, and all of the other witnesses.

Mr. Mackey, the Kentucky law now, how close is it in its requirements to what is being proposed in S. 2190?

Mr. MACKEY. Well, I think it is similar, and we recognize that we had a problem, and we could move rather quickly to try to solve it, and we still recognize that that isn't the answer to the problem. Commodities can move interstate, as you know, and we really believe that S. 2190 is the answer.

Senator HUDDLESTON. I think it is obvious that the uniformity has many advantages. Is Kentucky's new law working?

Mr. MACKEY. Well, we think it is working. It hasn't had that much experience yet. It was only passed in 1982, but as far as we can tell, it does help solve our problem.

Senator HUDDLESTON. Let me ask just for the record, why do you think we need this law as it relates to agricultural product sales? Also, for the record, what is the difference between purchases of agricultural products and the automobile dealers who have to

check their liens and make sure they are buying a free and clear product, or real estate salesman?

Mr. MACKEY. You want me to answer that? I hadn't given that a lot of thought, but obviously when you are dealing with automobiles you have licensing, and so forth, that you go through, and there are a lot more opportunities to look at that product, because it is only licensed in the area it is going to be sold, and livestock can just move or grain can move anywhere in the country.

Senator HUDDLESTON. Mr. Tritle, you have been on both sides of this issue.

Mr. TRITLE. I was going to say there is an identity problem on livestock now. In Montana where we handle some cattle, the identity problem ~~is not so~~ severe. You can brand cattle, but we handle a lot of dairy cattle in Minnesota and a lot of hogs. And we have not yet figured out a good way to establish individual identity of those animals.

Senator HUDDLESTON. Mr. Rohner?

Mr. ROHNER. Mr. Chairman, if I understand your question correctly, I am not sure that the proposed adjustment for farm products would be unique or extraordinary, but rather, would bring farm products into line with other commercial forms of inventory.

For years the inventory rule under the UCC is the same as the rule proposed here. It reinforces the conclusion that the buyer, in the ordinary course of business, of regular inventory, would buy a refrigerator in a store, and would take it free and clear. Even the retailer buying from the wholesaler buys free and clear.

Senator HUDDLESTON. What about a grain situation?

Mr. MACKEY. With grain, it would be hard to do.

Senator HUDDLESTON. When a producer sells his commodity to either a broker or a processor of meat, is there generally a formal contract used in the transaction?

Mr. TILGHMAN. There are documents.

Senator HUDDLESTON. Does that contract contain a question as to whether or not there is any lien on his commodity?

Mr. TILGHMAN. Usually the checks will show it.

Senator HUDDLESTON. I am thinking about before the checks are written, though. When the product is actually sold, is the buyer asked directly, or does a question appear in his sales contract asking whether the crop was used as collateral to secure a loan?

Mr. TILGHMAN. Not really.

Mr. TRITLE. In our case, not as a general practice. We would handle in St. Paul, for instance, 400 or 500 transactions a day, and those are usually one step removed from the farmer, because they come in via the trucker, and the only paper coming in is some direction as to which firm to use.

Senator HUDDLESTON. I believe Mr. Tritle, that you suggested that the responsibility should be shared among the borrower, lender, and purchaser. Maybe the purchaser ought to be more direct in asking the seller whether or not the crop has a lien on it and at least get it on record.

Mr. TRITLE. Our interest would be in having some means by which to cover a period of time, to have some notice from a borrower that for the next year, or 18 months or such, that's the way the facts are. To do it on each transaction would be somewhat difficult.

Mr. MACKEY. Mr. Chairman, I can see where a farmer living in Kentucky could negotiate with a trucker from Indiana, come over get my grain, take it to the elevator, bring me the proceeds. Take your truck and bill out of it, and you can do that very easily.

Senator HUDDLESTON. I wasn't suggesting that as being the primary way of doing it.

Mr. MACKEY. I am sure that could be done.

Mr. ROHNER. Theoretically you could have that inquiry made of the seller. But the seller at the point of sale may not know, may not have that information. Or the producer may lie. In fact, it is precisely in the case of producers who are tempted to dissipate those proceeds that the buyer's problem is most severe.

Mr. TRITLE. Mr. Chairman, we do business with a lot of customers, but it tends to be repeat business, and when a new customer comes along we make some inquiries we don't normally make. The problems we are having with present law are with old customers with whom we have relations.

Senator HUDDLESTON. What has your experience been, Mr. Tritle, in the number of actual instances where the product has been paid for twice?

Mr. TRITLE. We carry insurance from the Hartford Insurance Co. to cover the instances of having to pay twice for a commodity, and what that does, that insurance covers us unless we have some direct knowledge of the security, so what that has done has shifted, without a very clear definition of what direct notice is, it has shifted the debate to an argument between the insurance company and us, as to whether our claim is good. As to what kind of losses we have incurred, I would avoid saying, because we have some ongoing debates with insurance companies.

Senator HUDDLESTON. It almost put you into a position of not wanting to know, didn't it?

Mr. TRITLE. We would rather not. And when we debate what the direct notice is, and if the lender is to have the means to give us direct notice, I think it has to be defined, it has to be in writing, by registered mail. It should be individual notice. We don't want a thousand names at a time. We have a dispute going on with our insurance company now in which they are making the argument that because a letter went from a lender to another party in our business that we should have known about this security interest. We, of course, argue that we didn't know about it.

Senator HUDDLESTON. Professor Rohner, in a recent Law Review article the author states that, if Congress repealed the farm exception in the Uniform Commercial Code, credit would not be available for the younger and not-well established farmer. In addition, the author believes that the most appropriate body to consider the problem is the Permanent Editorial Board of the Uniform Commercial Code. Are you familiar with the Law Review article?

Mr. ROHNER. I am not sure I have seen that particular article, but I have heard that proposition before. It is absolutely something the subcommittee should look at very closely, the possible impact.

We have no doubt that, with Congress' interest in this whole area, it would take steps to make sure that doesn't happen. Also, the California experience suggests it won't happen.

Senator HUDDLESTON. Ray, do you have any comment on that?

Mr. MACKEY. Well, I think it might cause lenders to go back to looking a little more at the individual and whether he has honesty, integrity, and make those loans of those kinds even with less security than you might otherwise.

Senator HUDDLESTON. Most of our knowledge about these infractions and other things that occur comes from established organizations making purchases. Is there evidence of the problem arising when one farmer buys from another that you are aware of, or in the case when a small broker buys the products of several farmers and resells them? Have you had any instances where they have been——

Mr. MACKEY. Senator, I don't know of any specific instances of that nature, but the potential is certainly there, and the loss would be tremendous to a purchaser who had a chance to make a profit on a group of livestock, and then he had to pay for them again.

Senator HUDDLESTON. Gentlemen, thank you very much.

On the next panel are Dennis Casey, associate manager for government and industry affairs, Livestock Marketing Association, accompanied by Ernest Van Hooser, Van Hooser & Olsen, P.C., Kansas City, MO; Don Meers, vice president, audit and review, Federal Intermediate Credit Bank of Louisville, accompanied by Steve Phelps, vice president and assistant general counsel, Farm Credit Banks of St. Louis, representing the Farm Credit Council; Fred W. Greer, Jr., senior vice president, Citizens and Southern National Bank, and chairman, agricultural bankers division, American Bankers Association; Gary Wrage, Nebraska Bankers Association, Lincoln, NE; and Thomas H. Olson, president, Lisco State Bank, Lisco, NE, on behalf of the Independent Bankers Association of America.

We will start on my left. Please summarize your testimony. Your full statements will be included in the record.

STATEMENT OF DENNIS D. CASEY, ASSOCIATE MANAGER, GOVERNMENT AND INDUSTRY AFFAIRS, ON BEHALF OF THE LIVESTOCK MARKETING ASSOCIATION, ACCOMPANIED BY ERNEST H. VAN HOOSER, VAN HOOSER & OLSEN, P.C.

Mr. CASEY. Mr. Chairman and members of the subcommittee, my name is Dennis Casey, and on behalf of Livestock Marketing Association, it is my privilege to appear today and speak to the issue addressed in S. 2190.

With me is Ernest Van Hooser of the Kansas City law firm of Van Hooser & Olsen, P.C.[1] And before I summarize my statement, Mr. Chairman, and ask Mr. Van Hooser to address the committee also, please allow me to introduce three gentlemen who are attending the hearing with us.

Earl Britton is the president of the Livestock Marketing Association. Mr. Britton has livestock interests in Butte, MT. James Seabeck is from Spokane and operates a market there and at other locations in the State of Washington. And our general manager, Jim Fries, who is, of course, from the Kansas City office.

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[1] See p. 120 for the prepared statement of Mr. Van Hooser.

The Livestock Marketing Association is a trade group made up of some 1,400 businesses. These businesses merchandise livestock. They consist of all types of business organizations from single proprietorship to farmer cooperatives. They face the same problems as other small businesses do with, perhaps, a larger degree of financial risks, and perhaps a larger array of regulations. However, the industry has adjusted to change over the years while continuing to provide a marketplace that is open and competitive. However, large segments of the marketing industry are now threatened as they never have been before by circumstances which are commonly referred to as "mortgaged farm products."

This situation is created as a result of State laws—the Uniform Commercial Codes—which allow unpaid lenders to demand payment from buyers and/or markets of farm products, even though payment has been made to the seller. Unfortunately, all too often, and with increasing frequency, livestock marketing businesses have had to do just that, pay twice for livestock. The figures provided by Farmers Home Administration showed the dramatic growth in claims. In 1978, the FmHA referred to the USDA's Office of General Counsel 105 livestock claims totaling $508,130. In fiscal year 1982, the comparative numbers were 292 and $4,004,680 and, in fiscal year 1983, 263 and $4,494,950.

Although precise measurement is probably not possible with regard to all lenders, I can assure the subcommittee that similar growth in demands by other lenders has occurred.

The troubled farm economy of recent years is a significant factor in the larger numbers of claims by lenders whose loans have not been repaid. That economic situation continues and necessitates greater direct involvement by Government lending agencies and by arrangements whereby Government and private lenders together provide financial assistance to farmers.

Our experience indicates, however, that as the need for farm assistance increases, the number of loans which go unpaid also grow and, the losses by marketing businesses as a result of having to pay twice for the same product become more numerous.

Livestock marketing associations have been supportive of those State legislatures which have amended the Uniform Commercial Code as it applies to this area of farm product liens. Those actions have focused attention on a subject that was little understood. However, since the marketing of livestock and other farm products is very much interstate, there is a need for uniformity. That can be accomplished by the passage of Federal legislation.

S. 2190 is the vehicle which can correct outdated and unfair laws. Livestock Marketing Association urges your support of the bill.

Thank you.

Mr. Van Hooser would also like to speak to this subject.

Mr. VAN HOOSER. My name is Ernest Van Hooser. Given the time, I think I could sit here for hours, perhaps even days, and recount horror stories where livestock dealers and livestock marketing agencies have paid twice for livestock. I could quote statistics to show how the problem has grown, especially over the past 4 to 5 years. I could tell you about cases where the Farmers Home Administration has filed suit against buyers of livestock 3, 4, and 5

years after the sales transaction, despite the FmHA's contention that it has a self-imposed 1-year statute of limitations on bringing such actions.

I could describe how the present statutes in this area not only cost buyers of livestock who wind up paying twice, but also actually cost farmers and consumers of farm products.

I could explain how it is practically impossible for livestock buyers and livestock markets to run lien checks, because of the Packers and Stockyards Act prompt payment law. But you have heard, and I am sure will hear, much of this discussed by other speakers today.

Therefore, I shall try to limit my comments to two issues, why Federal legislation is needed and why the Livestock Marketing Association believes that there should be a small amendment to S. 2190.

As to the issue of why Federal legislation is needed, there are at least two primary reasons for Federal legislation with respect to mortgaged farm products.

As you have already heard, there are a number of State statutes, State legislation that has been passed in 16 different States. Some of that legislation deals only with grain, some deals only with livestock, some deals with all farm products. Some protect commission merchants, some protect buyers, some protect both. Some have actual notice provisions and some have certificate of ownership provisions. Some have provisions to shorten the statute of limitations, some have criminal penalties. It is a mish-mash. It is a hodgepodge at this point. The court decisions in the States are also a hodgepodge.

So the first reason for Federal legislation is to remove an impediment to interstate commerce. State legislation and those court decisions, because of their disparity, have created almost as many problems as they have solved. Today's markets for agricultural products are, for the most part, national, or at least regional. They are not confined to a single State. In my work I have three ring binders on the credenza behind my desk with State laws, because if someone calls and wants to know what they must do, it is impossible to know what all those laws are without something to refer to for, basically, what amounts to differences in State law and their applicability to farm products.

The second reason why Federal legislation is needed is to protect buyers of farm products against the Federal Government. State legislation may protect buyers or commission merchants from one of the largest lenders in the country, the Federal Government, but we really don't know at this point. It is a well-settled proposition that with a lender from the Federal Government, Federal law applies, but the question that is still open right now, despite a couple of cases, is whether that Federal law will be a uniform judicially constructed court law, or whether it will be an incorporated State law. And at this time there is a split in the circuits. Three circuits have decisions on the books where the liability of commission merchants is determined under a uniform Federal law. Four circuits have incorporated State laws as the Federal law. Thus, I believe until the Congress determines the law, either by dictating the use of judicially determined uniform Federal law, or by incorporating State law,

or Congress provides specific substantive law to be followed, the only way to determine what protection, if any, is available to buyers when the Federal Government is the lender will be to litigate the issue on a case-by-case, circuit-by-circuit basis, until it eventually gets to the Supreme Court for a decision.

Clearly, I don't feel that is a very healthy environment to conduct business.

The second issue I wanted to talk about just briefly has to do with commission merchants. Although most of the testimony here today will focus on buyers of farm products, it should be noted that commission merchants, such as livestock marketing agencies, are just as liable in dealing in farm products as buyers of farm products. Livestock markets are seldom buyers. They do not take ownership of the livestock but, instead, act as an intermediary to move the livestock from the seller to the buyer.

Since we believe the intent of S. 2190 was to provide protection to both buyers and commission merchants, we would suggest that S. 2190 be amended to include language such as that as is in my written statement, which I ask to be included as written.

This is a growing problem, a nationwide problem, it is affecting all agricultural commodities, and that is the reason why we believe that Federal legislation is needed to correct the problem.

Thank you.

Senator HUDDLESTON. Thank you. Next is Mr. Meers.

STATEMENT OF DONALD MEERS, VICE PRESIDENT, AUDIT AND REVIEW, FEDERAL INTERMEDIATE CREDIT BANK OF LOUISVILLE, ACCOMPANIED BY STEVE PHELPS, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, FARM CREDIT BANKS OF ST. LOUIS, ON BEHALF OF THE FARM CREDIT COUNCIL

Mr. MEERS. Mr. Chairman, my name is Donald Meers. I appreciate this opportunity to testify on behalf of the Farm Credit Council. I am a vice president of the Federal Land Bank and the Federal Intermediate Credit Bank of Louisville. With me is Mr. Stephen Phelps. He is a vice president and assistant general counsel of the Farm Credit Banks of St. Louis.

Late in 1982, through efforts of leaders from the Nation's farm credit banks, a district farm credit council was chartered in each of the Nation's farm credit districts. Each of those district councils is a regional trade association of cooperative farm lenders with membership drawn from the borrower-owned farm credit banks and associations and other cooperative farm lenders within its region.

Together with the Central Bank for Cooperatives, these 12 district councils comprise the membership of the federated national Farm Credit Council. I appear on behalf of those member institutions which, as of June 30, 1984, had collectively some $81 billion in loans outstanding to over 1 million farmer-owners and some 3,400 farmer cooperatives nationwide. That amounts to roughly a third of the Nation's total farm debt.

We are particularly pleased that you have provided this forum in which to gather information on legislation which is of vital concern to the Farm Credit Council. Included among the council's members are the 13 banks for cooperatives which are owned by the farmer

cooperatives to which those banks loaned almost $9 billion during the 6-month period ended June 30, 1984. Much of that credit was in the form of loans to grain and livestock marketing cooperatives to fund their purchases of farm commodities.

On the other hand, the Federal intermediate credit banks, production credit associations, and other cooperative farm lenders are also among the membership of the district councils. Within that 6-month period ended June 30, 1984, they made $16.2 billion in agricultural loans. On that date, these organizations accounted for some 20 percent of the Nation's non-real-estate farm debt with loans outstanding of approximately $19.5 billion.

Thus, we are keenly interested in protecting both the production lender as well as the buyers of farm products. Toward that end, a farm credit task force on farm products liens was appointed in the summer of 1983 to address the issues encompassed by the legislation before this subcommittee today.

This six-member group, of which Mr. Phelps and I are both members, is comprised of an attorney and a senior credit officer, each from a Federal land bank, a Federal intermediate credit bank and a bank for cooperatives. If I may, Mr. Chairman, I would like to submit a copy of that task force report for inclusion in the record.[1]

Mr. Chairman, we recognize that a serious problem exists—one that challenges all parties involved in a mortgaged commodities transaction. Under present law, the lien notice procedure is cumbersome to the point that buyers often ignore it. In some States, the lien information may be inadequate or difficult to locate. Often time constraints on livestock sales do not allow for a thorough and adequate search by the buyer. Many States have recognized this. By our count, 21 have considered corrected legislation and 13 have enacted some legislation into law. These State actions have included a central filing system, actual lender notice of security interests, producer certifications of ownership, buyer issuance of joint checks to the producer and lender(s), criminal penalties for producers who divert funds, and shortening of the statute of limitations.

By Federal preemption, S. 2190 would effectively delete the farm products exception contained in section 9–307 of the Uniform Commercial Code.

We oppose S. 2190 and any other proposal the effect of which would be solely to delete the farm products exception. Further, we would prefer that the issue be addressed at the State level.

We believe the undertaking of the farm production lender is unique. We believe it was in recognition of that fact that the farm products exception was included in the code just as it had been the law in most States prior to the code.

There are fundamental differences between crops and livestock on the one hand, and nonfarm commercial inventory on the other. Seldom are farm products sold one by one like inventory off the shelf. Often they are sold in bulk—that is, it is not irregular for the total of the crop or livestock security to be sold in a single transaction. Here the biological production cycle comes into play. Whether the collateral is calf or corn production, once the year's

[1] See p. 80 for a reprint of the task force report.

crop is marketed, there is no replacement crop to maintain the lender's collateral position.

According to the loan plan, proceeds are not reinvested in a replacement crop but are generally applied to retire the secured loan. What happens, then, if the producer fails to apply the sales proceeds from his crop to his production loan?

As a result of a single transaction, the lender could very likely find itself in a seriously undersecured, if not totally unsecured, position. More importantly, the lender will have lost not only its collateral but also the primary, if not exclusive, source for repayment of the loan.

Whereas critics of this exception believe that farm lenders enjoy a special privilege, I believe that it is the farmer who is the beneficiary of the current law. Our primary concern is the adverse impact that legislation like S. 2190 would have on the availability of credit to farmers for production purposes.

Federal action to only remove the farm products exception to the UCC would significantly reduce a farmer's basis for credit and at a time when already many farmers are finding it difficult, if not impossible, to obtain needed financing. At the very least, it would increase interest rates to farmers.

Let me elaborate on these points. In the extension of farm operating credit, the growing crop, stored crops, and livestock are the major collateral and source of repayment for the loan. If S. 2190 were enacted, a perfected security interest on farm products would be meaningless as against buyers. Without some discipline to ensure the buyers' assistance in application of sale proceeds to the loan, any prudent lender would be forced to omit or severely discount the value of these assets as loan collateral. The amount of credit available to a given borrower would be reduced accordingly. To the extent they are available, more emphasis would have to be placed on security interests taken on machinery and real estate as a basis for operating credit.

Today, we in Farm Credit, are straining to find a basis for continued financing of many farmers who have no real estate to mortgage, who have no equity left in their land, and who are young and beginning farmers or otherwise highly leveraged operators. When crop and livestock collateral values are discounted, these are the people whose borrowing power will be reduced.

In addition, S. 2190 would necessarily shift increased losses to the lender. In cooperative lending organizations such as PCA's, those losses must be spread among all members through higher interest rates. Under today's farm financial conditions, any increase in the interest rate will adversely impact the ability of many producers to remain in operation.

Mr. Chairman, S. 2190 will not put lenders out of business. Our concern is that it will put farmers out of business.

In many States, we in Farm Credit have worked toward reasonable solutions at the State level. We expect to continue in those efforts. We believe it is in the interest of all parties in the industry to see that the farm products lien is paid. We believe that any change in the law should by a balancing of responsibility recognize that need among buyers, lenders and producers.

But, shifting all the burden onto the lender—as S. 2190 would do—is not a viable solution. It would create an equally unworkable situation for lenders; it would remove all discipline from the marketing custom. It would do nothing to deter diversions of mortgaged farm commodities. It would reduce the amount of credit available to individual borrowers while adding to interest costs. S. 2190 would be extremely disruptive of the current lending environment that is already shaken to its foundation by continued low commodity prices, a decline in export markets, deteriorated land values and high interest rates.

Mr. Chairman, it will take shared effort and responsibility on the part of lenders, purchasers, and producers to reach a fair resolution of the farm products lien problem. Our preference is for solutions which are tailored to the particular region and general constraints of individual States. In our opinion, this approach would be far better than any nationally imposed solution that does not take into account the differing needs and situations of each State or region of the country.

The Farm Credit Council is again grateful for the opportunity to express its views before this subcommittee. Along with Mr. Phelps, I will be available to answer your questions.

Senator HUDDLESTON. Thank you very much. I will have some in a few minutes.

Now, Mr. Greer.

STATEMENT OF FRED W. GREER, JR., SENIOR VICE PRESIDENT, CITIZENS AND SOUTHERN NATIONAL BANK, AND CHAIRMAN, AGRICULTURAL BANKERS DIVISION, AMERICAN BANKERS ASSOCIATION

Mr. GREER. Mr. Chairman and members of the committee, I am Fred W. Greer, Jr., senior vice president of the Citizens and Southern National Bank in Atlanta, GA, and chairman of the agricultural bankers division of the American Bankers Association. Our association is comprised of over 13,000 full service banks which make up approximately 90 percent of this Nation's commercial banking community.

At the outset, I would like to express the American Bankers Association's appreciation for being given this opportunity to present the banking industry's views on the legislation introduced by Senator Huddleston.

As I will discuss in my statement, the proposed bill, if enacted, would have a serious detrimental effect on the many members of our association who make agricultural loans and on the ability of lenders in general to meet the credit needs of a vital sector of this Nation's economy. This bill also ignores the substantial interest that States have in this area of the law.

S. 2190 would eliminate a provision in section 9-307(1) of the Uniform Commercial Code popularly known as the "farm products exception."

Section 9-307(1) creates an exception to the general rule of article 9 that a security interest in collateral survives the sale or any other subsequent transfer of that collateral.

Section 9-307(1) States that where collateral is inventory in the hands of the seller and is sold to a buyer in the ordinary course of the seller's business, a good-faith purchaser takes free and clear of any security interest which the seller may have created in that collateral.

The farm products exception to the rule of section 9-307(1) provides that a buyer who purchases farm products from a person engaged in farming takes those products subject to any outstanding liens.

In the normal course of farming operations, the farm product exception rarely causes any problems for the purchaser of agricultural products. For example, the sale of products often falls outside the farm products exception because they are made with the express or implied consent of the lien holder. In these cases, the buyer would take free and clear of the lender's security interest.

It is, therefore, only in the small percentage of cases where an "unauthorized" sale is made and the seller fails to pay off its lender that the exception to section 9-307(1) comes into play.

S. 2190 would effectively repeal the farm product exception now contained in the Uniform Commercial Code and remove the protection given lenders by the present law. S. 2190 would place within the coverage of section 9-307(1) all farm products presently excepted from that section.

Our association feels that the removal of the farm product exception is an attempt to equalize the buyers of farm products with other purchasers of "inventory" which overlooks both the historical rationale for the exception and the real commercial difference between financing farm production and other types of business inventory.

With respect to the historical development of the farm product exception, it should be noted that the enactment of section 9-307(1) did nothing to alter the prior common law.

It is clear that in the overwhelming majority of jurisdictions which considered this issue, courts held that purchasers of farm products took those products subject to the lenders' liens.

Several factors support the logic of the farm product exception. The commercial realities of financing the production of farm products differ from those associated with financing other types of business inventory.

The typical situation in which section 9-307(1) protects the buyer from liens is when a businessman or woman sells stock in trade in numerous small transactions to a great many anonymous, financially unsophisticated buyers. In the course business, the seller uses the proceeds from these transactions to replenish the inventory in order to make further sales.

Unlike the situation just described, the farmer's "stock in trade;" his livestock, grain or other produce, is the product of a biological production cycle which is financed by the lender's credit. The creditor's loans are used to produce (e.g. grow grain, fatten livestock, et cetera) the items which the farmer eventually sells. These farm products usually represent the lender's only security for his loans.

When the products are sold, the proceeds are generally not used to purchase more "inventory" for the farmer to sell but to retire the loans which produced the collateral sold. If the proceeds are

not used in this manner, the lender loses the proceeds and the best means of satisfying the loan. Without the farm products exception, agricultural lenders would be without one of the most effective means of ensuring payment of their loans.

In addition, unlike typical sales of inventory, farm products are generally sold in bulk transactions to a few sophisticated buyers. These buyers are aware of the methods of financing farm production and, therefore, do not need the protection afforded to other purchasers by section 9–307.

Finally, depriving the agricultural lenders of the benefits of the farm product exception would put these lenders in a less favorable position under the Uniform Commercial Code vis-a-vis other financers of inventory.

While the bulk transfer provisions in article 6 of the UCC protect, for the most part, lenders who finance inventory from unauthorized transfers of that inventory by their borrowers, farm lenders fall outside the provisions of article 6 because most farmers sell farm products in bulk and article 6 only applies to enterprises whose principal business is the sale of merchandise from stock.

I would now like to turn from the rationale for the farm products exception to address some of the major complaints raised by the purchasers of farm products. First and foremost is the so-called problem of "double jeopardy," the notion that a buyer is forced to pay twice because the farmer failed to apply the proceeds to satisfy the lien on the products.

The intent of our association is certainly not to belittle the difficulty faced by a purchaser who must pay twice, however, the "problem" of double payment is certainly avoidable under the present financing scheme of article 9 (which is enacted in all States but Louisiana). By checking for liens recorded by the lender, purchasers of farm products are in a position to protect themselves from the possibility of double jeopardy.

While searching for liens may entail some effort on the part of buyers, it is certainly not any more burdensome than the task faced by creditors when creating the liens in the first place.

In addition, as will be discussed in a moment, many States, through recently enacted legislation, are moving to decrease the burden on purchasers by making it easier to discover the existence of outstanding liens.

As this committee is aware, the area of secured lending is a matter which has been traditionally left to the States. The enactment of article 9 of the UCC in 49 States illustrates the commitment by the States to stay abreast of the changes in this technical area of the law.

Moreover, the legislative activities in a number of regions of the country during 1983 demonstrates that the States have a firm grip on the situation facing the buyers of farm products. In all, some 16 States enacted legislation which in some way addressed the complaints made by the buyers.

The various responses include centralized filing of liens, 24-hour access to filing information, certification by the seller to the buyer regarding the existence of liens and various other techniques for protecting buyers. Of the 16 States which have considered the

issue, only Tennessee has responded in the manner proposed by these bills.

The American Bankers Association opposes any efforts to eliminate the lenders' ability to rely on perfected agricultural liens to enforce debt obligations. The removal of this protection, as proposed in S. 2190 would have the effect of substantially reducing the willingness of creditors to lend to farmers.

In order to attain the same level of protection against default which is provided by the farm products exception, lenders would be forced to seek more collateral for their loans or to lend only to those farmers who qualify for unsecured loans. In either case, the cost of credit would increase while the overall amount of available farm credit would be reduced.

These bills, while granting purchasers of farm products protection, would punish a great number of lenders and honest farmers for the acts of the few unscrupulous agricultural borrowers who do not repay their loans.

In summary, I would like to state that the American Bankers Association understands that the growing and rapidly changing marketplace for agricultural goods has created complexities for both lenders in knowing the purchasers of their borrowers' products, and buyers in discovering the existence of recorded liens.

While this situation may call for some technical adjustments, it certainly does not justify rearranging the traditional relationship between agricultural lenders and the purchasers of farm products which would result from the enactment of this proposed legislation.

Thank you very much.

Senator HUDDLESTON. Thank you.

Gentlemen, the committee is going to recess for about 5 minutes.

[Recess.]

Senator HUDDLESTON. We are ready to resume.

We will move to Mr. Wrage.

STATEMENT OF GARY WRAGE, CHAIRMAN, ROSELAND STATE BANK, ROSELAND, NE, ON BEHALF OF THE NEBRASKA BANKERS ASSOCIATION

Mr. WRAGE. Mr. Chairman and members of the committee, my name is Gary Wrage and I appear today as spokesman for the Nebraska Bankers Association, Inc., a trade association representing 459 of the 463 commercial banks in Nebraska.

As you are aware, Nebraska is a highly agricultural-livestock intensive State and is suffering severe stress as the result of the recent economic recession compounded by recent additional losses due to drought and flood.

I speak in opposition to S. 2190, and any other Federal preemption of the Uniform Commercial Code section 9-307, farm products exception, sometimes referred to as a "double jeopardy" provision of the code.

At this critical time in the lives of many Nebraska and other farmers, we must be very careful so that in the guise of providing an easier way for some members of our society to transact business or to provide an economic benefit to other businessmen, that we do

not inadvertently destroy the basis upon which most farm credit is today predicated.

Let me say very clearly, there is no such thing as double jeopardy under section 9-307 of the Uniform Commercial Code, which has been the law subject to a few recent exceptions of all but one State for many years. As a matter of fact, the code simply restates the law in regard to the purchase of farm products as has existed for many years prior to the Uniform Commercial Code in most States.

Back to double jeopardy. All one has to do for maximum protection in the purchase of farm products is to check under the notice provision of the Uniform Commercial Code in a similar manner as every lender must do to perfect a lien priority in the first place.

One of the basic tenets of a Uniform Commercial Code lien is notice to the world, which is commonly referred to as the perfection, which, when coupled with the agreement of the borrower in writing that a lien will attach provides a perfected lien it establishes a priority upon which the world can rely. No one has bothered to check properly—and this includes the great majority of the purchasers of farm products—has ever lost a dime.

We hear the arguments that buyers of farm products are somehow treated differently. Let's examine the facts. As you are aware, one of the purposes of the Uniform Commercial Code was to provide an economic atmosphere that would allow a maximum of credit and a maximum of a free flow of commercial transactions.

Prior to the adoption of the code there was extreme difficulty with liens on inventory, with liens on after-acquired property or on crops to be grown. Exact descriptions were required to keep from having a lien defeated. This applied to everyone, farmers, merchants and all segments of our economy.

The framers of the code searched for and found new ways to provide security for additional loans especially in the area of inventory liens.

In the case of most business inventories it was necessary that protections be established, which was done by providing severe sanctions in the event the merchant disposed of all or the greater portion of his inventory without complying with strict creditor notification and protection procedures. This protection was developed in article 6 of this code, bulk transfers.

It was also obvious that it was necessary that a purchaser of a single item of that inventory had to have assurances that he could purchase free of a lien. The farmer and buyers of farm products normally have the characteristics of inventory—in fact, the code calls them inventory if they leave the possession of the producer and are not sold.

The framers of the code left the old rule, the law of many years, in place, which only required that a buyer check to see if someone else might not have an interest in the farm product.

There is a vast difference between an individual buying one fan or one refrigerator from a merchant and the grain elevator that buys a farmer's complete or greater part of his inventory.

The framers of the code were given another opportunity to address the issues presented by S. 2190 when the commissioners on uniform state laws prepared and proposed the 1972 amendments to

the code, which have been adopted by most States. Again, the specific issue of the buyer of farm products under 9-307 was considered and rejected as detrimental to lending.

Let's for the moment discuss purchasers of farm products other than grain buyers. Livestock markets in Nebraska have a fairly favored treatment in that they may sell free of the lien so long as they announce the name and address of the owner of the livestock prior to the sale. Most do not choose to do this and elect instead to insure against a possible loss. Processing markets have even a better opportunity to check than most.

While I understand that most processors prefer to insure, it would seem that the very practice of viewing the livestock in the owner's lot on one or more occasions would afford ample opportunity to check the record prior to consummating the purchase.

The then president of the Nebraska Bankers Association in 1982 testified before the Agricultural Committee of the Nebraska Legislature at a hearing concerning a similar proposal at the State level. It was his opinion, and very obvious upon examination of the facts, that the only protection a lender would have in the event this provision becomes law would be to withhold credit.

If lenders are not able to secure their loans for seed, fertilizer, fuel, chemicals, irrigation expenses, with the crop that is a result of these loans and to be able to rely thereon, it follows that the loans will not be made.

There was further testimony that from 5 percent to 10 percent of the farmers, amounting to a withdrawal from the economy of several hundred million dollars, would be denied credit who otherwise would be deserving, in order that lenders could adequately protect their portfolios.

This, by the way, would naturally hit hardest the young farmers and the farmer who is already having a difficult time, the very people to whom most of the effort today is being directed to assist in keeping agriculture a viable life form.

There is an even greater reason that a solution be found to our so-called double jeopardy concern, which affects agricultural lenders and others.

We are aware that some buyers of farm products have also expanded their business and services, not only to furnishing feed and fertilizer but to the furnishing of a much wider list of products, including veterinary products and many others.

These products and services are often advanced during the summer months without adequate arrangements for payment and they, as everyone else who has an interest in the farmer's product, are undoubtedly looking to the same source for payment as the lender is looking for repayment.

Should a purchaser of farm products be enabled to acquire clear title notwithstanding any previous liens, that is, petroleum liens, fertilizer liens, and Uniform Commercial Code liens, nothing would prevent that purchaser from setting off his debt under the common law against the proceeds of that crop, thereby creating an undisclosed lien of greater magnitude and authority than anything that could be created by law.

There are some curable problems that have developed with our present notice system, such as lack of filing officer cooperation in

providing access to information and a lag time in filing because of sheer volume.

The Nebraska Legislature has directed the development of a central indexing system available 24 hours a day and accessible by nearly any communication means, including computer access.

The basic documents would remain on file for inspection much in the same manner as has been done over the years. This is a workable solution as, if we are to survive in our rural environment, we all must become more sophisticated and be willing to enter into the 21st century together with each bearing a share of the responsibility of making the society work.

This is obviously a local issue which would be best solved through State-by-State attention, and it necessarily follows that S. 2190 should progress no further.

Thank you for this opportunity to address this committee. I would be pleased to attempt to answer any question you might have.

Thank you.

Senator HUDDLESTON. Thank you very much.

Mr. Olson, you are next.

STATEMENT OF THOMAS H. OLSON, PRESIDENT, LISCO STATE BANK, LISCO, NE, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. OLSON. Thank you very much, Senator.

Mr. Chairman and members of the subcommittee:

I am Thomas H. Olson, chairman of the Agriculture-Rural Committee of the Independent Bankers Association of America and president of the Lisco State Bank in Lisco, NE.

We commend you for holding these hearings on the problem of enforcing liens on farm products, because the collection and sharing of information on these procedures is critical.

The IBAA had occasion to review our position on this issue on June 13, when our officers and 20 banker Agriculture-Rural Committee reexamined the issue at a meeting held in Omaha, NE.

We are opposed to the enactment of S. 2190. Lenders, producers, buyers, and marketers all have a vital stake in the practice of secured, collateralized farm lending. Buyers and commission sales houses play a very important role in enforcing liens and preventing the conversion of mortgaged assets. We are experiencing problems in many areas with these procedures—problems which are exaggerated by the financially stressed condition of many farm and livestock producers today. To cope with these problems, changes in procedures are being made in the States to enable lenders and buyers to jointly enforce liens more effectively and economically.

In our judgment, the legislatures of the various States are the places to make these changes. There is little evidence of real interest in fashioning a preemptive Federal policy which would continue the benefits of present procedures in enforcing liens and focus on improving those procedures. For instance, any attempt to establish a nationwide central filing system at this time would likely prove very difficult and overburdensome.

About one-third of the States have made substantial changes recently in their laws on this subject. The States are experimenting with a variety of procedures, including central filing, a certificate of ownership at point of sale, prior notice to buyers by lenders, strengthened penalties against sellers for conversion of mortgaged property, and other practices. Some States are now going through a second round of adjustments.

For instance, North Dakota is considering a possible change whereby a central filing system may be instituted for livestock while retaining a certificate of ownership for grain—based upon the fact that grain sales by farmers in North Dakota tend to involve local elevators within counties whereas livestock sales often occur on a multicounty basis.

In making changes within the States, many of the State legislatures are establishing special committees to study the problems before acting, and these committees explore the practices and changes that are occurring in other States. To the extent that certain procedures seem to be uniformly workable, one would expect the States to adopt common procedures.

As indicated by the widespread activity within the States, real problems are being encountered by buyers who often find it difficult to secure timely information on the mortgaged status of farm products offered for sale. Lenders are also harmed to the extent that the process of checking liens is difficult and inefficient, and we are working with other groups within the States on constructive changes.

Despite the problems, the present legal system under UCC section 9-307(1) has meant that buyers and commission sales houses tend to keep in contact with lenders regarding their purchases of farm products in ways that enable commerce in farm products to be conducted freely, but also consistently with the enforcement of liens, in the vast majority of sales. In dealing with the problems involved, we must not lose sight of this crucial working procedure which is predicated on section 9-307(1)—and which would be lost if the farm products provision of the UCC were to be repealed.

The farm products exception in the UCC is fully justifiable, in view of the special importance of soundly collateralized credits in the financing of agriculture.

Unlike fixed location assets such as houses, land, and other buildings, farm products are mobile and impossible for the lender to make subject to continuous observation. For these reasons, UCC 9-307(1) enlists the buyer in helping to police the disposition of mortgaged farm products where the security is perfected and filed. This is the system through which tens of billions of dollars of production financing is extended to agricultural producers annually.

It has pointed out that buyers and marketers of farm products can ill afford to pay twice for the same products. Likewise, however, the lender can ill afford to have collateral converted at this time when cash-flow and other farm income is often inadequate to repay debt owed to the lender. As indicated, the active involvement of buyers and marketers under the UCC is very important in enforcing farm credit liens.

Perhaps some figures on the current financial status of the banking industry, and agricultural banks in particular, would be useful

in emphasizing the importance of protecting loan collateral. A total of 58 banks have failed so far this year, compared with 48 during all of 1983. Over 700 institutions are now on the FDIC's list of seriously troubled banks. Formal enforcment orders, mostly cease and desist orders, issued by the FDIC and Comptroller of the Currency totaled 57 in 1981, 101 in 1982, and 301 in 1983—or an almost 200-percent increase from 1982 to 1983.

Although those figures represent all insured commercial banks, the Nation's 4,300 agriculture banks, with at least 25 percent of their loan portfolio in farm loans include a small but increasing number of banks that are under serious financial stress. In 1983, average loan losses at agricultural banks reached 0.93 percent, up 375 percent from the average of loan losses during the 10 years 1970–79. Thirteen percent of the 4,300 agricultural banks, or some 559 banks, showed 4 percent or less of net income as a percentage of equity in 1983, and 7 percent of those banks, or about 301 banks, showed a negative return on equity in 1983.

These figures should not cause concern with regard to FDIC insured commercial banks, but they demonstrate that the capacity of depository institutions in agricultural areas to incur loan losses is strictly limited. At the end of 1983, average available capital in agricultural banks was 9 percent of loans and other assets, and almost 1,000 banks had more than 70 percent of their total loans in agriculture. Obviously, it is vitally important to protect loan collateral under these circumstances, since the basis for incurring loan losses is strictly limited.

The protection afforded to farm loan collateral by the farm products provision of the UCC is also important in holding down the incidences of classified loans and adverse actions on loan cases which can result from such classifications. The IBAA has repeatedly expressed concern to the bank regulators—the Comptroller, FDIC, and Federal Reserve, that bank examiners should refrain from classifying agricultural loans as substandard or problem loans, if the secured collateral behind the loan is adequate.

In other words, even if the farmer or livestock producers' current cash flow from farming operations is inadequate to fully service his debt as presently structured, the loan case should not be classified if the assets which collateralize the loan are adequate and if the lender can work with the producer on managing the debt during this period of high real interest rates and financial stress in agriculture.

I have attached to this statement a copy of IBAA's most recent exchange of correspondence with the bank regulators regarding loan classifications, which followed our discussion of the problem in Omaha on June 13.

Comptroller C.T. Conover's response, dated July 12, stated:

> Sound banking practice precludes undue reliance on secondary sources of repayment, such as collateral, to liquidate debt. The support provided by collateral, however, strengthens a credit; and, the quality and marketability of the collateral are factors that are considered in the valuation of the credit. . . . While we continue to uphold traditional credit standards, examiners support well-reasoned work-out plans.

We could not make this case for greater reliance on the loan security as a basis on which to buy time for work-out plans on farm

loans if the buyer's role in policing loan security at the point of sale under the UCC was undermined or removed.

In sum, we believe that we must maintain and improve the practicality of the procedures under UCC section 9-307(1) by working through the legislatures of the States, which have the primary jurisdiction over the areas of law and practice which are involved.

Senator HUDDLESTON. Thank you, Mr. Olson.

Mr. Phelps, would you like to make a comment?

Mr. PHELPS. I would be happy to respond to any questions you might have.

Senator HUDDLESTON. I would assume the people from the financial institutions don't see this as a major problem the way that the purchasers do. How do you see the situation working now in Kentucky, Mr. Meers?

Mr. MEERS. The situation in Kentucky, where there is State law, has worked reasonably well. There is the opportunity for notification there. I visited with some of our associations yesterday, before I came up here, in fact.

It is being dealt with in the State, and they don't see any real concern with it. They are able to notify the buyers, and it is functioning satisfactorily for them. I asked them if they lost that ability to provide notification, what it would do to them. And everyone I spoke to said it would change our ability to lend. There would be certain people we can't lend to.

Senator HUDDLESTON. But if there is a solution or one can be worked out that would make a shared responsibility, wouldn't it be better to have it on a uniform, nationwide basis rather than just have each State do its own thing? What do you think?

Mr. MEERS. I am sure there is a lot of people that feel that way, particularly on the buyers' side. From the feedback we get across the country from our different farm credit districts, the problems seem to be different in different places.

The solutions, hence, have been somewhat different. We find ourselves with a large number of States having dealt with it in their way now being faced with having to change that again.

I think that has caused a lot of discomfort for many of our districts.

Senator HUDDLESTON. Mr. Olson?

Mr. OLSON. I feel that there is enough difference, Senator, in the areas and the regions that one Federal policy would not necessarily be the solution.

Again, I look at the cumbersomeness of it, and maybe the cost of it, and I just feel that if each individual State is given that opportunity, and I recognize that there is obviously a purchasing of commodities from one State to another State, but it seems like in certain regions it may work better than just doing it on a Federal basis.

Senator HUDDLESTON. Does the rest of the panel agree?

Mr. GREER. I certainly concur, Mr. Chairman. I don't think I can add anything specifically to Mr. Meers and Mr. Olson. The facts have made changes on an individual State basis, and indeed, there is a difference from section to section.

Again, along the lines of what Mr. Olson mentioned, our executive committee of the Agricultural Bankers Association talked

about this on a State-by-State basis. We have 14 members of that committee, one of whom is from Kentucky, and he backs up what Mr. Meers says, and certainly the rest of us are opposed to any change at the time.

Mr. PHELPS. Mr. Chairman, if I could add something there to the comments.

Senator HUDDLESTON. Please do.

Mr. PHELPS. In the State of Illinois, which is where many credit associations that I represent operate, the PCA's and buyer groups enthusiastically support a bill, and it went into effect 1 year ago this month, that was patterned after the Kentucky legislation.

In the State of Missouri, buyer groups, and many they have who are clients of Mr. Van Hooser, were unable to support that type of bill, but they did support a bill very much like Mr. Tritle discussed earlier.

In the State of Arkansas, neither of those approaches met with the support of buyer or lender groups.

In the State of Arkansas, the grain dealers indicated they had no problem with the present law, and it was strictly a livestock problem, and what I am suggesting is, there have definitely been significant differences from State to State, and even where buyer and lender groups have reached agreement within States, those agreements have tended to differ significantly across State lines.

Senator HUDDLESTON. Mr. Olson, it has been pointed out that S. 2190 does not preclude the lender from taking other steps to protect his collateral or protect himself.

Are you familiar with what might be happening in California, where the farm products exemption has been repealed? What are Californians doing to further protect their interest?

Mr. OLSON. Senator, I am not that familiar with California. I know that State has used every example in terms of not ever repealing that section, so I can't expand on that.

Senator HUDDLESTON. Mr. Greer?

Mr. GREER. Senator, I will comment on that. Not that I have that firsthand, but we have customers in that State, and, as a matter of fact, one of our committee members is from California. We discussed this and as Mr. Olson said, from what we can all gather, California is unique in many ways, but agriculture also, in that a great portion of the agriculture production in California is co-op, and direct contract agricultural production. Fruits and vegetables, the grape industry, milk, and so forth, and before that crop even goes into the ground to be produced for the year, a direct contract is made with Welch, Sunkist, or whoever it might be, and the lenders know their customers. They are big farmers, and not a lot of little ones scattered around such as in Kentucky, and so forth, and they can take direct assignment of that contract up front, and thus alleviate some problems like we just discussed.

Senator HUDDLESTON. Is it standard practice for a contract to make reference to liens and require a person who is selling the product to declare whether or not there is a lien against his product?

Mr. GREER. I couldn't answer that question, Senator, in the sense, again, I am from a different State, and not up on the exact details of how it is handled in California.

Mr. CASEY. Senator, I am not sure how they market vegetables, but I can assure the Senator that the marketing of livestock in California is similar to other States.

Senator HUDDLESTON. Do you know what happens in California, as far as the lending institutions are concerned? How are they dealing with the repeal that they have out there?

Mr. CASEY. To our knowledge, we are not aware of any livestock claims against a buyer or market at this time.

One other point, Senator, if I might. There seems to be a misconception among some lenders, that buyers and/or markets can protect themselves by merely, or simply checking the existence of liens at the county courthouse, or in some cases, a department of the State government.

Let me submit to the committee that in most cases it is impractical for a livestock market to determine the existence of liens for all consignors and in many cases, impossible. That is because a normal, a common auction market day has consignors from several counties. In some cases, several hundreds of consignors, whose livestock not only originate in the county in which the market is located, but the surrounding counties, outlying counties, and even across State borders. Couple that with the regulations under which those markets operate by which payment from the livestock must be made within 24 hours of the sale, and I think that you can readily see that there is no possible way in which all those consignments could be checked for the existence of liens.

Mr. PHELPS. Mr. Chairman, could I respond to Mr. Casey's comments?

Senator HUDDLESTON. Sure.

Mr. PHELPS. No member of the lending community at this table has suggested today that the status quo ought to remain what it is. Mr. Wrage commented that there is a means by which buyers can protect themselves by checking the record, but I didn't hear him suggest that it was necessarily practical in all respects.

What members of the lending community say today is that essentially what we are searching for on a State-by-State basis is a means to facilitate buyers' knowledge of liens, not merely to rely on some existing filing system.

I think our point of disagreement is not on whether the status quo is a viable alternative I think most of the members of the lending community recognize it as a problem, and in the State of Nebraska they are addressing this with a type of central filing, which is yet, again, different from many approaches that we have been discussing. So I don't—I think it is a mistake, and I don't think lenders are adhering to the status quo.

We are searching for ways to facilitate buyers obtaining knowledge of the lien without at the same time undercutting the protection that lenders need in order to continue to extend credit to the extent to the number of borrowers that we presently do.

Senator HUDDLESTON. Gentlemen, thank you very much.

On our last panel will be Rich McKee, executive secretary, Feedlot Division, Kansas Livestock Association, on behalf of the National Cattlemen's Association; Steve Kopperud, legislative director, American Feed Manufacturers Association, Inc., and Neal P.

Gillen, vice president and general counsel, American Cotton Shippers Association.

We will start with Mr. McKee.

STATEMENT OF RICH McKEE, EXECUTIVE SECRETARY, FEEDLOT DIVISION, KANSAS LIVESTOCK ASSOCIATION, ON BEHALF OF THE NATIONAL CATTLEMEN'S ASSOCIATION

Mr. McKee. Thank you, Mr. Chairman. I am Rich McKee, and I am here testifying on behalf of the National Cattlemen's Association. I am executive secretary of the Kansas Livestock Association's Feedlot Division.[1]

The Kansas Livestock Association, along with the National Cattlemen's Association, support S. 2190, and thank you for the opportunity to allow us to present testimony, and I commend you for introducing the bill.

We do feel, however, that there are several problems in the treatment of agricultural products under the UCC, and before I paraphrase any more of my testimony, Mr. Chairman, I would like to state now that even though we have a disagreement on this one issue, that we do consider those in the financial institutions our friends.

Clear title is a key issue for our membership, as our members are both buyers and sellers of agricultural products. Agricultural producers, and especially livestock operators, deal in a large geographical area, including State-to-State, multistate, and it is not uncommon for livestock operators in Kansas to get cattle from Florida, California, and even Kentucky.

Some have argued and said today that if clear title were passed for agricultural products, that available credit will in fact dry up for agricultural endeavors, and that interest rates will rise dramatically for those trying to get money for agricultural endeavors.

I submit to you that that would not be the case, and I think California is a good example to use. The availability of credit to agricultural operators in California has in fact increased compared to the rest of the country since 1976, when clear title was passed for agricultural products.

I am a little puzzled by the fact that I have heard two arguments given by those representing financial institutions today. One, that it is not a big problem in financial institutions, double payment, as we call it, in our association, but would be a big enough problem that if clear title was given for products, collateral would "dry up" and that interest rates would rise.

I would also ask myself the question that if those involved in agricultural endeavors are getting preferential treatment in the form of lower interest rates and less collateral required, why is the interest rate not cheaper for those in agriculture versus all other products which pass clear title today? And if it is, I am not aware of where it is cheaper.

Some have even said, Mr. Chairman, that if clear title passed for agricultural products, that that would eliminate one of the most effective means of insuring payment of their loans. Now at least to

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[1] See p. 112 for the prepared statement of Mr. McKee.

me that argument points out the total inequity in the current law, and that third-party buyers should not be forced to pay for the same cattle, grain, or hogs twice.

We seek changes because there is currently a burden to free trade in agricultural products. There is a variance from State to State laws, and that makes the issue worse and more confusing.

In short, our members feel that financial institutions are in the financial risk-taking endeavor, and not the purchaser. We also feel that the financial institutions loan to the debtor, not the purchaser.

We also feel that the innocent buyer can't determine whom the institution has loaned to. And, finally, we feel that the innocent buyer of agricultural products should not be forced to police loans for financial institutions.

In closing, we support your bill, Senator Huddleston, S. 2190, and in short, I guess I can best summarize our position in cowboy terminology, as that is whom our association represents. They feel, "If you buy it, pay good money for it, that you ought to own it!"

Thank you.

Senator HUDDLESTON. Mr. Kopperud.

STATEMENT OF STEVEN L. KOPPERUD, LEGISLATIVE DIRECTOR, THE AMERICAN FEED MANUFACTURERS ASSOCIATION

Mr. KOPPERUD. Senator Huddleston, I am Steve Kopperud, legislative director for the American Feed Manufacturers Association [AFMA]. AFMA is the national trade association representing the manufacturers of over 70 percent of the primary formula livestock and poultry feed sold in the United States each year.

The issue we address today is relatively simple: how to rebalance the scales so that buyers of farm products no longer bear all risk in agricultural lending.

Our members are constantly at risk of double payment—once to the farmer, once to the bank—if that security interest is undisclosed to the buyer and the farmer defaults on the loan.

Our industry annually buys $10 to $15 billion in feed ingredients, mostly grain and byproducts, making the U.S. feed industry the single largest domestic user of grain. Undisclosed crop liens represent a major uncontrolled cost factor to the feed industry. Feed represents 50–75 percent of the cost of producing meat, milk, and eggs at the farm level. Feed ingredients on average represent about 80 percent of the selling price of commercial formula feeds. Anything which increases our cost of doing business over the long run must be reflected in the cost of our products to the farmer and, ultimately, in the consumer cost of meat, milk, and eggs.

We will briefly describe the current situation facing the Nation's feed manufacturers. We will also provide some valuable insight into the situation in California, a State which removed the farm products exception effective in 1976. The California data has been provided by the California Grain and Feed Association.

An earlier witness has said, we've "Never lost a dime?" We've lost a lot of dimes. AFMA surveyed its membership on double payment and came up with some sobering statistics. Consider the following:

Forty percent of the 170 feed companies responding to our survey indicated either a moderate or serious problem with undisclosed crop liens;

Of those indicating they had a problem, claims ranged from $2,500 to $50,000.

Exposure levels were reported at a low of $50,000 for small companies, to as much as $4 million for large, multi-State firms. The average risk exposure level was around $1 million.

Our problem originates with both private and Government lenders with about equal frequency. A December 1982 Farmers Home Administration survey, which included grain liens for the first time, revealed a total of $7.2 million in grain production loans referred to regional offices of general counsel during 1982 for serious delinquency or default. This was nearly $600,000 more than livestock loans referred during the same period.

You will hear that farm product purchasers can protect themselves by simply checking the proper authorities for liens when they buy farm products.

The cost of checking liens on all grain purchased for feed manufacturing—in payments and man-hours—is staggering, especially for firms doing business in more than one county in more than one State.

For the past several years, the States have individually attempted to bring some reason to this situation. However, in those efforts, the States have created a crazy quilt of agricultural lending regulations that makes doing business among States even more complex than before.

The witness list at today's hearing includes a broad coalition of agricultural interests which have come to the same conclusion: Federal preemption of State law is necessary to provide relief and bring consistency to laws governing agricultural product purchases. The situation in California presents the most encouraging evidence that this is possible with little or no impact on agricultural lending.

As CGFA executive vice president Richard Matteis states: "We [California] are the State with firsthand knowledge of and practical experience with a system which insures that buyers of farm products have clear title to the commodities they buy."

Effective January 1, 1976, section 9-307(1) of the California Commercial Code was amended to delete the farm products exception. This change extended to the buyers of farm products the same protections provided to buyers of other goods. "Since that time, we know of no occasion when a buyer of farm products has had to pay twice for the same commodity. Representatives of the California Bankers Association have asserted to this fact," according to CGFA.

"Most of what you have heard from opponents of clear title legislation is conjecture, while we have emprical evidence that providing such protections to buyers of farm products is actually of benefit to all concerned parties—purchasers, growers and lenders," according to California Grain and Feed.

The California situation works like this: A "buyer in the ordinary course of business" takes farm product purchases free and

clear of any lien "even though the security interest is perfected and even though the buyer knows of its existence."

Under the California Code, one of the definitions of "buyer in the ordinary course of business" is that the buyer be "without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party."

This has led many California lenders to protect their interests by routinely notifying potential buyers that the security interest exists, even though the California Code does not expressly call for any type of pre-notice. Checks may then be made out jointly to the lender and the farmer by the buyer. CGFA says this had led to a "simple, effective system with all parties adequately protected."

The California experience also negates the argument that to remove the farm products exception will place agricultural lending in jeopardy. "In California, most farmers require some degree of operational financing," says CGFA. "I can tell you there are a multitude of agricultural lenders ready, willing and able to provide the required financing at rates that are affordable, despite the changes made to section 9-307(1)—I have never heard of a single instance of a grower not being provided financing because of the clear title issue."

As to the loss of the farm products exception acting to artificially increase the cost of credit, California Grain and Feed reports that discussions with agricultural lenders within California indicate that the interest rate charged on a production loan is generally directly related to the perceived ability of the grower to repay the loan. This is as it should be. (Argues that farm loans should be at lower rate than normal loans.)

You will hear that the California experience is not germane to the national discussion of clear title because somehow California is unique. First, by no means is all production co-op marketed. California is unique in that it is the largest agricultural producer in the country—and has remained so since removing the farm products exception. It markets more agricultural products than any other State—and has retained that distinction without the farm products exception. Says California Grain and Feed's Matteis:

> I believe the differences between California and other States are minimal with regard to the clear title issue. The banks do have a greater responsibility than in other States . . . But it is not the burden many are claiming, and in fact, has advantages for lenders as well. There is no reason our system cannot work equally well in other States.

At question, then, is the lenders' willingness to accept the risks along with the profits inherent in prudent agricultural lending.

No feed manufacturer can stay in business over the long run unless he recovers all of his costs.

Thus, from the standpoint of grain, the current unfair situation created by the farm products exception discriminates against livestock and poultry producers by adding to their costs of production, and by extension against the consumer through higher prices for meat, milk, and eggs.

AFMA strongly supports legislation like S. 2190, that will return consistency to State regulation of agricultural farm purchases and end discriminatory treatment under the Uniform Commercial Code for buyers, sellers and lenders alike.

We thank the subcommittee for its time and consideration.

Senator HUDDLESTON. Thank you very much.

Mr. Gillen, you are next.

STATEMENT OF NEAL P. GILLEN, VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN COTTON SHIPPERS ASSOCIATION

Mr. GILLEN. Thank you, Senator.

Mr. Chairman, I am Neal P. Gillen, vice president and general counsel of the American Cotton Shippers Association. Our member firms conducting business in the 16 Cotton Belt States purchase and sell 80 percent of the cotton sold to U.S. mills and 90 percent of the cotton sold in the export market.

I appear today to express the support of the association for S. 2190 which amends section 9-307(1) of the Uniform Commercial Code allowing purchasers of farm products in the ordinary course of business to purchase such goods free of any perfected security interest.

At this point I would like to introduce for the record a statement of Ms. Nancy Patton, a young woman in the cotton business in Lubbock, TX, who is, coincidentally, affected by this provision of the code.[1]

Senator HUDDLESTON. I will be glad to place that statement in the record.

Mr. GILLEN. Section 9-307(1) provides that:

> A buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

Through section 9-307(1) agricultural lenders are placed in a more secure position than commercial lenders, and the purchasers of agricultural products are subject to a burden not placed upon the purchasers of industrial products or consumer goods, given that the buyers of agricultural products are placed in the role of guarantors in the event that the producer does not repay his or her loan with the proceeds from the sale of crops or livestock.

The complexities of the Uniform Commercial Code place too onerous a burden on the initial purchaser of agricultural commodities, thus hindering the trade in such goods. Unlike the purchasers of other goods, an agricultural purchaser is required to conduct a lien search, similar to a title search on real estate, in each county clerk's office in the counties that the producer owns or leases land on which crops or livestock are raised.

Crop liens are recorded with the liens on cars, campers, furniture, appliances, and other personal property, are not necessarily listed in alphabetical order, not always in the best handwriting, do not list the amount of the crop lien, and do not specifically identify the type of crop or livestock subject to the lien. If one undertakes the time and expense to conduct a lien search, and does in fact uncover a lien, it is necessary to contact the lending agency to determine what crops—cotton, wheat, corn, soybeans, et cetera—or what type of livestock—cattle, hogs, sheep, et cetera—is subject to a lien.

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[1] See p. 164 for the statement of Ms. Patton.

If the crop or livestock purchased is under lien or liens, the buyer may be obliged to make payment jointly or severally to the farmer and the lending agencies. Liens generally cannot be searched through a telephone call, and if the search is conducted by a county employee, a service charge not less than $5 per search is usually charged.

And I might add parenthetically these searches are not timely, and these county employees have rather extraordinary hours, I might add. Better than bankers, I might add.

The initial purchaser of farm products, be it a cattle barn, country elevator, or country cotton buyer, is ill equipped to undertake a search of lien ledgers in county courthouses, and cannot afford the additional overhead necessitated by lien searches. When crops move at harvest, the elevator operator finds farm trucks lined up with grain to be weighted, sampled, offloaded, and warehouse receipts to be issued, and little or no time to call or visit the county clerk's office to inquire about crop liens.

The Packers and Stockyards Act requires the cattle barn operator to make payment for livestock prior to the close of business the following day, making the lien search almost a moot question. The country cotton buyer usually purchases all or a substantial part of the cotton processed at a particular gin with payment made to the gin. Here, the buyer has no idea of the identity of the farmers and potential liability hinges upon whether the ginner acted as the agent of the buyer or the farmer. Another factor is the delays inherent in a proper lien search which could prove costly to the seller or the buyer in times of fluctuating prices. And I might add parenthetically in the case of Ms. Patton, she has a business with 3 employees, which she inherited from her father, and in the immedate area of Lubbock there are 25 cotton producing counties. Cotton is also bought and sold in Oklahoma and in the south Texas market. It is virtually impossible, with that type of staffing, to do such searches by telephone. That is the common situation for the local grain elevator, cattle barn or country cotton merchant. These people have few employees and are capitalized on a very small basis.

Let me review some experience in the cotton industry.

At the outset of the 1982 marketing season it was apparent that a substantial portion of the cotton crop was encumbered by liens. I advised our members to presume that a lien existed, cautioned them to determine whether in fact a lien existed, and if so, to make payment jointly and/or severally to the producer and the lien holder.

This advisory procedure proved difficult, if not impossible, to implement by those buying cotton in the country, and they were quick to inform me that such was the case. I visited a number of cotton firms in the Midsouth and Southwest to investigate the problem, and to discuss what could be done to limit or ease the burden of determining the existence of a lien and the identity of the lien holder. The personal inspection of lien ledgers by me, other attorneys and cotton buyers in county courthouses throughout the Cotton Belt revealed an inconsistent and sometimes incomprehensible system of recording liens.

At the county clerk's office in Lubbock, TX, I discovered the names of two farmers with FmHA liens recorded on their 1981 and 1982 crops, but when I checked the list of crop liens at the FmHA office, in the Federal building across the street, the names were not listed, and the clerk had no explanation for the discrepancy. The converse was also evident in that the name of a producer listed on the FmHA list could not be found in the county clerk's office.

Mr. Chairman, why must a buyer of farm products in the ordinary course of business be subject to such a burden, such confusion?

I believe this morning that Professor Rohner discussed with you in depth the case history and legal analysis of cases that have been tried and interpreted under section 9-307(1) and other sections of the code.

And to add to the frustration of those in our business, I might just read to you briefly an excerpt from a recent case that was decided by the fifth circuit, called *United States* v. *Weems*.

In 1977, the farmer Weems, had pledged his cotton and soybean crop to FmHA. The crops were sold without notice to or the consent of FmHA. The farmer identified himself as Jack Weems, giving his address as Delhi or Baskin, Louisiana and represented the crop was unencumbered by a lien. The buyers checked the FmHA list of crop liens which listed Charles R. Weems, neglecting to check if Charles R. and Jack were the same individual.

The court discussed the fact that the due care of the buyer, not his good faith, is the appropriate standard. The real issue was the validity of the crop lien, and that when the lien is properly recorded, it is effective against third persons so that the immediate purchaser of a crop subject to the lien buys with constructive notice of the pledge, and is personally liable to the crop pledges, or at least up to the value of the crop purchased by him.

In a case pending in Alabama, a member firm purchased 1980 cotton subject to a crop lien, and FmHA is requesting payment. The buyer asked the farmer if the crop was subject to a bank lien. The farmer answered the question affirmatively and the merchant made payment to the farmer and the bank. The farmer failed to mention the existence of an FmHA lien, and FmHA is seeking indemnity from the merchant, the farmer being insolvent. I have found out that a settlement is being reached by FmHA. The merchant has been advised to pay it in order to avoid litigation, and he has paid for that crop one and a half times.

I will add parenthetically that in Ms. Patton's case, she purchased 70 bales of cotton from a farmer indebted to a bank. She paid $14,600 for that cotton, and the farmer deposited her check in the same bank from which he received the loan, and that money was in that bank for some 30 days. The farmer eventually declared bankruptcy. The bank began proceedings against him, and the bank has gone under. It has been taken over by the FDIC. And you have the unique situation where you have a bankrupt farmer, a bankrupt bank, and you may well have a bankrupt cotton merchant.

The Farmer prefers to deal with a local buyer, someone he knows and can trust. The buyer in turn must trust his customer.

The UCC, however, holds him liable if the farmer defaults on his loan, a loan to which he was not a party, but a loan on which he may be a guarantor. This onerous burden hinders the efficient marketing of cotton and should be deleted from the UCC.

Should farm lending agencies be placed in a position superior to that of the purchaser of the farmer's production?

Should the purchaser be required to police the lending agency's loan?

Should the purchaser be required to pay the creditor when the creditor has failed to properly supervise its accounts?

Should purchasers of nonagricultural products enjoy special treatment under the Uniform Commercial Code?

Each question merits a negative response in 1984, given the changes that have occurred in agricultural production, marketing, and banking since the UCC was drafted in the 1950's.

The need to amend section 9-307(1) is compelling and long overdue. Over the course of the past year, efforts have been underway in a number of States to enact legislation similar to that passed by California in 1974. Our association has been active in a number of cotton-producing States, and I have personally appeared and testified in Oklahoma and Texas.

Members of the various legislatures uniformly share our concern, understand the problem, but have no uniform solution.

Our successful experience in Oklahoma and Tennessee evinces that for each legislature there is a different solution. The need for uniformity is essential, and we believe that it can only be achieved through an act of Congress.

Given that Congress and the U.S. Supreme Court deem agricultural products to directly burden or affect interstate commerce, the Congress has authority to preempt the individual States by enacting laws dealing with the sale of agricultural products, and since section 9-307(1) clearly places a burden on the interstate sale of agricultural products the need for Congress to act is compelling.

Thank you for this opportunity to relate our experience with section 9-307(1) and to express our views on the need to amend 9-307(1) through an Act of Congress.

Thank you.

Senator HUDDLESTON. Thank you.

On the California case, do you know any instances where the lending institution has lost its collateral and in fact lost the money on a loan?

Mr. KOPPERUD. I really can't address that. I can say there have been no claims against our people in California since 1976, when the change became effective. I really can't speak for the lenders.

Mr. GILLEN. Senator, in California, coincidentally, the largest money crop in California is cotton, and the majority of the farmers in the State are noncooperative, however, there is a close balance there.

I have spoken to a number of bankers. The first two bankers to whom I talked did not even realize that the code had been changed. The banks are those who financed the purchase of farm commodities, and these banks in California have a rather large agricultural involvement. It is a very hands-on involvement, and I have not been made aware of any problems, even though California, like all

other farmer States, has its share of farmers who are suffering, given the economy, and the oversupply of many products which have depressed prices. And so as these gentlemen have said, and I think as the American Meat Institute has demonstrated, that the evidence is clear. Agricultural lending in California has increased.

I don't think there is any relationship between the amended code and the increase, but certainly it is proof positive that the concerns I have heard voiced here this morning, and the State legislators I have appeared before have no basis in fact.

The gentleman said this morning, that in Kentucky, which has changed the law, the change has not affected the amount of credit that is available, That is the red herring that you hear in the State houses where this legislation was pending. Credit is going to dry up if this passes, we are not going to have any money available for farmers, and that is not true.

Senator HUDDLESTON. Do you all see the need for lenders to share the responsibility? If so, how could that best be done?

Mr. GILLEN. I think it is the seller's responsibility. He is the one who has taken the loan. But there is a standard in banking known as the three C's—character, collateral and I forget the third C at the moment.

Senator HUDDLESTON. Collection, probably. [Laughter.]

Mr. GILLEN. In my mind, in most of my experiences in dealing with banks, proper supervision of the loan portfolio is the solution to the problem. That is what I heard discussed here this morning.

Senator HUDDLESTON. But how are the banks going to keep up with all this transfer of commodities and livestock from one county to the other?

Mr. GILLEN. Well, I know in the livestock business they go out and check those pens every week, and sometimes twice a week.

Senator HUDDLESTON. The banker?

Mr. GILLEN. I have been out there when the bank account comes out and count the cattle in the individual numbered pens.

Senator HUDDLESTON. Maybe they can sell them before the day's over.

Mr. MCKEE. Mr. Chairman, I might add, that is not the case in Kansas, and I will submit the reason why it is that financial institutions can always fall on the AMI members, the Meat Packers, to get payment for the loan, and I will also submit that if clear title was passed for agricultural products maybe they would get out there a little more often to count the cattle.

Senator HUDDLESTON. I am thinking we should not shift the responsibility entirely from one group to another.

Mr. KOPPERUD. Senator, as you have pointed out, the risk of lending money was not unknown to the banks when they got into it. At the same time, I would agree with Neal, that it behooves the bank to first make and approve second loans, and then police them adequately. That is not to say there shouldn't be additional legal responsibility placed on the borrower. Under the informal——

Senator HUDDLESTON. But might there not be some validity to the argument that if you impose greater responsibility on the bank to assure a prudent loan for this particular segment, that the banker might just lend his money for something that he can keep a better check on.

Mr. Gillen, Senator, your point is well taken. I know in the Oklahoma legislature, the compromise that was reached there requires that a farmer sign a statement upon which he indicates whether or not there is a lien on the commodity.

Senator HUDDLESTON. That is when he sells it.

Mr. GILLEN. Yes, sir. And on that he lists the lien holder. In that situation, where there is a lien, and he lists it, the buyer makes the check out jointly to the farmer and to the lien holder.

In instances where there is no lien, he just makes the check out to the farmer and in the event there is a lien, there is a criminal penalty subject to fine and imprisonment for one year.

Senator HUDDLESTON. How does this help? He gets little satisfaction out of sending a man to jail if he loses his money.

Mr. MCKEE. Mr. Chairman, maybe financial institutions could purchase insurance like our buyers have to now to protect themselves as innocent third-party buyers.

Mr. GILLEN. Well, this provision passed the Banking Committee of the Oklahoma Senate by 14 to 2, and the Oklahoma State Bankers Association, I met with them, seemed satisfied with that compromise. I might add that it passed the Agriculture Committee in the House by 20 to 0. Seventy-five witnesses testified. Cattle barn operators, grain elevator operators, and they made an extremely persuasive case, and the legislature acted within a period of about 2 weeks.

Senator HUDDLESTON. Do you think there is any reason to believe that the failure of the borrower to notify the purchaser that a lien exists could be because of his lack of understanding that he is required to do so?

Isn't this information getting to the seller that this is something that he is obligated to do?

Mr. GILLEN. Senator, with all due respect to people of whom you speak, I would think that the U.S. farmers are probably the more expert on credit and borrowing money than most people in our society. It is a heavily leveraged operation.

In incidences where there have been defaults, it is in those situations that are few and far between where you have someone who is down on his luck, and the old saying goes, you can never tell how honest a man is until he is down on his luck; and you have these situations where people just default, and there are some bad apples out there, and there are just some people who are in extremes financially.

Mr. KOPPERUD. There is a certain segment, and I think it would be fair to say it is a relatively small segment of producers, who in many cases have moved to the situation where they routinely use this protection. They are sophisticated in knowing the extent the banks have. They just step away from it. All they have to do is default, and the bank is equally aware of that.

Senator HUDDLESTON. Gentlemen, thank you very much. I appreciate your testimony, and the testimony of all the witnesses. This will be very helpful to our committee.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

STATEMENT OF WILLIS G. MOREMEN, EXECUTIVE VICE PRESIDENT, KENTUCKY BANKERS ASSOCIATION

In Kentucky, the availability of agricultural credit is an important part of the economy, and I oppose S. 2190 because its passage in its present form could cause a significant portion of that credit to cease to exist.

My concern is not for the banks - they will find other ways to employ their loan funds - but it is for some farmers who may no longer be able to obtain farm production loans.

S. 2190 would effectively repeal the "farm products exception" found in Section 9-307(1) of the Uniform Commercial Code which has been adopted in Kentucky and all other states. This "exception" enables lenders whose loans are secured by farm products to enforce their security interest against the buyers of the crops of livestock given as collateral. Under S. 2190 this would no longer be the case, and farm products collateral would have no value at all in making farm production loans. In effect, these loans would be unsecured.

In addition, farm production loans are distinctive in that the collateral not only secures the loan but the proceeds of the crops or livestock collateralizing the loan are generally used to repay the loan. Having extended credit to a farmer on the strength of a self-liquidating lien the removal of the "farm products exemption" by S. 2190 would not only remove from agricultural lenders the means of policing their collateral but the principal source of the loan's repayment as well.

S. 2190 is of particular significance to the "share crop" farmer or the farmer whose farm and equipment are already highly encumbered. Often a production loan is the primary source of funds to plant a crop and sale of the crop is the only source of repayment. This is the case in Kentucky because of the importance of the tobacco industry where much of the crop is raised on a "share" basis. Passage of S. 2190 would remove the protection afforded the lender by the Uniform Commercial Code and transfer that protection solely to the buyer. In my judgment, this can only result in less credit being available to the farmer who needs it the most.

Moreover, the timing of consideration of S. 2190 is unfortunate in that a large number of Kentucky farmers are already having trouble obtaining credit because of the condition of the farm economy in general and the impact of adverse weather conditions in Kentucky in particular.

Kentucky has recognized that the "farm products exception" has created a problem for the buyer of farm products, the farmer and the lender and has amended Sec. 9-307(1) of the Code in an attempt to accommodate all three interests. Although the amendment is not a perfect solution, it represents a viable compromise and apparently has not resulted in any particular hardship.

Essentially, the Kentucky amendment requires a lender, desiring to preserve its security interest in tobacco, livestock, grain, a soybean crop or race horses sold through or to a licensed warehouse or stockyard or an organization engaged in the business of selling race horses, to give notice of its lien prior to sale of its collateral.

In conclusion, I would remind you that our concern is for the farmer and our desire to serve his needs while recognizing the problem created for the buyer of farm products. In Kentucky we have attempted to address those problems while maintaining the ability to serve the farmer's needs. I would hope S. 2190 or any comparable legislation would not be enacted as drafted.

Note: The Kentucky amendment to the Uniform Commercial Code referred to by Mr. Moremen reads as follows:

355.9-307 Protection of buyers of goods, crops and livestock

(1) A buyer in ordinary course of business (subsection (9) of KRS 355.1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

(2) If any tobacco crop subject to the lien of a security interest is sold at public auction through a duly licensed tobacco warehouse in the ordinary course of business, a bona fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouseman selling such tobacco crop shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail of such lien, the name and address of the debtor and proper description of the property subject to lien, are given to the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop.

(3) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current grain storage license issued by the Commonwealth of Kentucky or a current federal ware-

house storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail, of such lien, the name and address of the debtor and proper description of the property subject to the lien is given to the entity purchasing said crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(4) If any livestock subject to the lien of a security interest is sold at public auction through a stockyard licensed by the Commonwealth of Kentucky in the ordinary course of business, a bona fide purchaser for value of such livestock shall take title thereto free and clear of any such lien, and the stockyard and selling agents selling such livestock shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail of such lien, the name and address of the debtor and proper description of the livestock subject to lien is given to the stockyard prior to the time of sale.

(5) In the case of consumer goods and in the case of farm equipment having an original purchase price not in excess of $500 (other than fixtures, see KRS 355.9-313), a buyer takes free of a security interest even though perfected if he buys without knowledge of the security interest, for value and for his own personal, family or household purposes or his own farming operations unless prior to the purchase the secured party has filed a financing statement covering such goods.

(6) If any registered breed of horse, the racing of which is regulated by KRS Chapter 230, subject to the lien of a security interest is sold at public auction in the ordinary course of business by an organization engaged in the business of selling such horses at public auction, a bona fide purchaser for value of such horse shall take title thereto free and clear of any such lien, and the organization selling such horse shall not be liable to the holder of such lien, unless written notice by registered mail of such lien and the amount thereof, the name and address of the debtor and proper identification of the horse subject to lien are given to the organization prior to the time of sale.

STATEMENT OF RAY MACKEY, PRESIDENT, KENTUCKY FARM BUREAU FEDERATION, ON BEHALF OF THE AMERICAN FARM BUREAU FEDERATION

My name is Ray Mackey, President, Kentucky Farm Bureau Federation, and a grain, livestock and tobacco farmer from Elizabethtown, Kentucky. I am also a member of the American Farm Bureau Federation Board of Directors.

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BACKGROUND

Farm Bureau appreciates the opportunity to testify on the mortgaged agricultural commodities issue which is becoming an increasingly more onerous problem to a broad segment of agriculture. This statement is supported by Farmers Home Administration (FmHA) statistics (See Attachment I) which indicate that the problem in 1982 was larger in grain sales than in livestock sales despite the fact that the value of livestock cases pending showed an 850 percent increase from 1978-82. Cotton is not included in FmHA statistics, but testimony in the House Agriculture Committee indicated that there is a growing problem for this commodity also.

For a number of years the livestock and grain industries have been plagued by a difficult situation which adversely affects companies that handle sales transactions for farmers, ranchers and other sellers. The problem is created by a small minority of producers who illegally sell livestock, grain or other commodities which have an outstanding lien and, without paying the security holder, divert the funds to other uses. Third parties, i.e. market agents, packers, elevators and other parties without actual knowledge of the recorded liens, are liable to the security party for the value of the commodity and incur a loss equal to that value. As a result, the injured third party pays for a commodity twice, once to the seller and once to the bank as payment for the seller's loan.

IMPACT ON AGRICULTURE

We are concerned about this situation for three reasons:

First, it poses an undue financial hardship on markets to which producers sell their commodities. We are interested in any problem which reduces the economic viability of agricultural markets.

Second, as the problem continues to grow, it is adversely affecting individual farmers as well as the markets to whom farmers sell their products. Farmers buy products such as feeder cattle and pigs, and breeding stock from other producers. Under the current lien laws, farmer-buyers are required to make double payments when loans are not repaid to security holders.

Third, the current situation is inequitable. Section 9-307 of the Uniform Commercial Code states, "A buyer in ordinary course of business, other then a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfect and even though the buyer knows of its existence." In other words, buyers of products in the ordinary course of business are under no obligation to search for liens. However, because of the exception"...other than a person...in farming operations..." in Section 907, buyers of farm products must

search for liens and are liable to repay the loan if a lien exists.

This section of the Code, therefore, treats agricultural producers differently than any other businessmen and means that the purchaser of a farmer's grain or livestock is liable to pay for commodities twice when the producer fails to repay the lienholder for the mortgaged commodities. To avoid the double payment possibility, the buyer is expected to conduct a title search on the hundreds of sales transactions conducted daily. The title could be recorded in a county that is not even in the same state as the sale. The sale could also occur in the evening or on the weekend when county offices are not open.

It is unreasonable for the livestock market or grain elevator to become a credit supervisor for a lending institution. In effect, the buyer of farm products becomes the involuntary guarantor of a loan about which he knew nothing, in which he had no input as to the advisability of the loan or the limit of the credit granted, and for which he receives no compensation in the form of interest to cover risk exposure and jeopardy he has involuntarily and unknowingly assumed.

The inequity is especially apparent for the livestock market which does not have the protection of other buyers in commerce because of the lien laws, but is subject to the prompt payment requirement of Section 201.43 of the Packers and Stockyards Act.

WHY IS THERE A FARM PRODUCTS EXEMPTION?

The answer to this is unclear. The exemption appears to have been adopted by draftsmen of the Uniform Commercial Code because it was the predominant view of case law early in the 1960's. Case law probably supported the exemption because agriculture loans were difficult to supervise early in this country's history. Poor roads and communication made it difficult for lenders to check on loan collateral such as range cattle. However, this is certainly not the case today.

The exemption should be analyzed in terms of its application to modern agriculture. Tremendously improved transportation and communication networks make agricultural loan supervision easier.

Farm products are no different than other products sold in commerce and shouldn't receive different treatment. The current Code treats farmers as if they were unsophisticated businessmen. However, the management skills, technical knowledge and capital requirements in farming today are equal to those in most other businesses.

The inequitable situation faced by the buyer of farm products who pays for commodities twice is in sharp contrast to the favorable situation faced by the lender. For reasons which aren't clear, the agriculture exemption puts the agricultural creditor

in a less risky, more advantageous position than the inventory creditor. This inequity, which benefits one small group of individuals to the detriment and exclusion of the rights of others, must be corrected.

HOW WILL FARM CREDIT BE AFFECTED BY ELIMINATION OF THE EXEMPTION?

Lenders argue that the cost of credit will increase and the availability of credit will decrease if the exemption is eliminated. This hypothetical argument used by the lenders is without merit. If our leading state in agricultural production is an example of what will happen to agricultural credit upon removal of the exemption, then this is clearly not the case. In 1976, California eliminated the exemption and non-real estate farm loans increased in every year except one. The increase was at a more rapid rate than the national average. The harm presently being suffered by farmers far outweighs a speculative or unconfirmed concern that the elimination of the exemption might adversely affect farm credit.

When commercial banks throughout the country make loans to farmers, Section 9-307 is not taken into consideration. If it were, we think that farmers would pay less for credit and get more favorable credit terms than anybody else in regular commerce because there is less risk. Since farmers do not receive more favorable credit terms from commercial lenders, we don't feel that elimination of the exemption will have any effect.

Based on these arguments, we believe that agricultural lenders are opposed to elimination of the exemption because it lowers the risk on agricultural loans and allows less stringent loan supervision.

IS A FEDERAL OR STATE SOLUTION APPROPRIATE FOR THIS PROBLEM?

One of the effects of adoption of the Uniform Commercial Code by several states has been to facilitate interstate trade. The underlying purposes and policies of the Code are to clarify and modernize the law concerning commercial transactions; to permit continued expansion of commercial practices through custom, usage and agreement of the parties; and to make uniform the law among the various jurisdictions. Since it is also the specific intent of the Code that the courts be able to develop the law embodied therein in light of unforeseen and new circumstances and practices, it follows that the proper construction of the Code be in view of the above mentioned policies and purposes.

It is also important to note that significant quantities of grain and livestock are marketed across state lines. When encouraging Congress to pass grain elevator bankruptcy legislation, we argued that uniform state laws were necessary to facilitate agricultural trade. The same point is valid in this issue.

For these reasons we feel that a state solution to the problem is not appropriate. Senator Huddleston's bill, S. 2190, enables buyers of farm products to take title free of third-party security interest. This bill, with a minor amendment to protect livestock agents and auction markets, (See Attachment II) is the proper legislative solution.

KENTUCKY EXPERIENCE

In Kentucky, we have taken action to partly resolve the problem that develops when mortgaged agricultural commodities are sold. For example, Kentucky farmers have experienced the misfortune of losing a great deal of money from grain elevators and stockyard bankruptcies.

Often these bankruptcies were brought about because the market place was forced to pay twice for the same commodity which had been sold illegally. The double payment, therefore, jeopardizes the opportunity of other farmers who sell their products legally from receiving payment.

Kentucky's Commercial Code had for several years required that all selling agents, except tobacco warehousemen, be responsible for determining whether a lien exists on any item passing through his sales operation. Otherwise, the agent had been responsible to the lienholder for the amount of the lien. In 1982, we amended our state law by giving the same protection to licensed grain and livestock yard operators as was previously afforded tobacco warehousemen. Lienholders are now required to notify the market place either by certified or registered mail if they desire the market place to be responsible for the amount of the lien should the mortgaged property pass through the operation. If no such notice is given, the market place is not responsible.

Kentucky's law has worked very well, and I might add that agricultural credit is still available and our lending institutions have not fled the state as many might have suggested. Unless Congress takes action to solve the problem, many states will follow the ways of Kentucky by attempting to address the situation by adopting a wide range of legislative solutions. This action could possibly bring about additional problems due to the fact that the various state laws governing commerce will no longer be uniform.

We appreciate the interest and support this Subcommittee has shown in the mortgaged agricultural commodity problem and encourage you to consider a legislative solution similiar to S. 2190.

ATTACHMENT I

FmHA SUMMARY OF MORTGAGED COMMODITIES CASES

LIVESTOCK

	FISCAL YEAR	NUMBER	AMOUNT	AVERAGE SIZE
Referred to OGC*	1978	105	$ 508,130	$ 4,839
	1982	292	4,004,680	13,714
Collected	1978	56	120,447	2,151
	1982	51	383,055	7,511
Pending at OGC*	1978	128	766,663	5,989
	1982	595	6,581,968	11,062

GRAIN

	FISCAL YEAR	NUMBER	AMOUNT	AVERAGE SIZE
Referred to OGC*	1978	No Info	No Info	
	1982	199	$4,215,940	$21,185
Collected	1978	No Info	No Info	
	1982	54	517,428	9,582
Pending at OGC*	1978	No Info	No Info	
	1982	439	7,194,321	16,387

*USDA's Office of General Counsel

ATTACHMENT II

In order to protect the seller's agent, the following wording should be added to S. 2190:

A Commission merchant or selling agent who sells livestock or other agricultural products for others shall not be liable to the holder of a security interest in such livestock or other agricultural products, even though the security interest is perfected, if the sale is made in the oridinary course of business and without actual knowledge of the security interest.

STATEMENT OF RALPH J. ROHNER, THE COLUMBUS SCHOOL OF LAW, THE CATHOLIC UNIVERSITY OF AMERICA, ON BEHALF OF THE AMERICAN MEAT INSTITUTE

Mr. Chairman and Members of the Subcommittee:

I am Ralph J. Rohner, and I am a Professor of Law at the Catholic University of America in Washington, D.C., where I have taught courses in the commercial law area for twenty years. I appear today on behalf of the American Meat Institute, the national trade association representing packers and processors of meat and meat products. Accompanying me is Gary Jay Kushner, AMI's Vice President and General Counsel.

AMI wholeheartedly supports S. 2190, which seeks to remedy a situation that is simply fundamentally unfair to the purchasers of agricultural products, particularly livestock. Under the uniform commercial law in all states save California, purchasers who pay good money in good faith to sellers of farm products remain legally subject to the liens of lenders covering those farm products. If a seller/debtor defaults on the loan, or fails to account for the sale proceeds, the buyer can be forced to pay twice for the goods, once at the time of sale and again--often months or years later--when the bank or other lender sues the purchaser for conversion of its collateral. This result obtains because of an antiquated exception to the good faith purchaser rule in section 9-307 of the Uniform Commercial Code.

We have included as an appendix to our testimony an extensive analysis of this state law rule, and we would ask that the complete statement be included in the hearing record.

Hearings were held on this problem in the House Agriculture Committee last fall and again in July of this year. The record of those hearings is replete with first-hand testimony of the hardship and inequity caused by the UCC provision. The aggregate amount of claims filed by lenders against purchasers of crops and livestock easily runs into millions of dollars just based on the statements of those witnesses.

The source of the problem--the so-called "farm products exception" of the UCC--is, we submit, an unjustifiable rule of law that ought to be abrogated by federal statute, as S. 2190 would do.

Our extended statement describes the anomalous nature of the farm products exception, its uncertain history, its disfavored treatment by some courts, and its harsh and unpredictable burden on packers, processors, and other livestock buyers. To summarize:

The rule runs against the grain of general commercial law which seeks to encourage the free flow of commerce by protecting good faith purchasers from the risk of prior liens. Generally, the

law allows buyers who purchase goods in the normal course of business to pay and acquire full ownership. For example, when a customer pays a retailer for a refrigerator, the bank financing the retailer's inventory cannot thereafter pursue a claim against the custormer. The same policy would apply when the retailer purchases its stock of appliances from the manufacture: as a buyer in the ordinary course of business, the retailer would be protected from claims by the manufacturer's bank. By contrast the special rule for farm products frustrates the free movement of goods in commerce, and has never had clear policy justification.

Farm products purchasers are, as a practical matter, utterly unable to verify reliably the existence of security interests at the time of purchase. This is especially true of livestock buyers who, by federal law, must settle with the producer-seller at the point of sale or within twenty-four hours afterward. While we do not object to this prompt payment provision of the Packers and Stockyards Act, it clearly underscores the need for reform of the UCC.

The UCC filing system which theoretically discloses such liens, is generally based on filings in the producer's home county, a location which is effectively inaccessible in the short time frames in which farm products sales are conducted, particularly when those sales are conducted on an interstate basis.

The effect of the rule gives the farm products lender a set of involuntary guarantors on every loan it writes. A borrower's failure to account for the proceeds of sale becomes the risk not of the professional lender, but of the various innocent third parties downstream in the distribution chain.

In November hearings in the House, Mr. Jack Prophater, a Georgia livestock buyer, also reminded the Subcommittee of the risk of solvency that liability under the UCC farm products rule poses for buyers:

> Hardly a month goes by that we don't read of another meat packer filing bankruptcy and another livestock market for farmers being weakened thereby. If Sunnyland (Mr. Prophater's company) were to go under, 1,000 hard working, honest people in the small town we support would lose their jobs and a company that purchases nearly half of the over two million hogs produced in Georgia each year would be gone.

The persistence of the rule bodes ill for farm products purchasers, especially small operators who simply cannot afford to pay twice for their livestock.

S. 2190 recognizes the basic unfairness of the present farm products exception. The case against the rule is so strong and

self-evident--in law school we would say prima facie--that Congress' failure to act on it must be based on compelling grounds. We suggest, therefore, that the burden is on the agricutural lending industry to demonstrate a justification for continuing the rule. Their testimony in the House fails abjectly to make any such case, and we doubt they can strengthen their position here.

The lenders argue that commerce in farm products is somehow so unique--compared to other forms of commercial inventory--that the farm products exception is necessary for one but not the other. We deny any such uniqueness to farm products financing. Decisions to lend in all cases are based on prudent assessments of the borrower's capacity and character. The risks assumed by commercial inventory lenders always include the possible loss of collateral to third party buyers in the ordinary course of business; yet inventory financing flourishes. We have heard nothing that supports any claim by farm products lenders that their market uniquely entitles them to protections not avaliable to other commercial financers.

The lenders suggest that the buyers of agricultural products enjoy "inherent advantages" to protect against the risk of seller default. On the contrary, in the hurly-burly of cash sales, buyers are virtually powerless to determine the existence of outstanding liens and the identities of the lienholders. They buy blind. The lenders, on the other hand, are risk-taking professionals who ought to be able to monitor their debtors' activities sufficiently well to prevent dissipation of proceeds. It may well be that the farm products rule has resulted in shoddy lending practices.

Then the lenders raise the bogeyman objection that repeal of the farm products exception would substantially increase their financial losses and thus significantly raise the cost of credit. We disagree, especially with the adverbs "substantially" and significantly." Whatever impact a change in the law might have, its effects on the cost and availability of farm credit are likely to be negligible if even measureable. The state of California repealed the farm products exception in 1976; if there is any evidence that our largest agricultural state, or the lenders or producers within it, are suffering on that account, we are unaware of it. The likely reality is that, with the farm products exception gone, lenders will tighten their administrative supervision of producers to minimize the risk of unaccounted-for proceeds. It could be that changing the law in this regard will reduce lender losses by encouraging more prudent practices across the board.

Finally, the lenders argue that a number of states are experimenting with techniques to ameliorate the effects of the farm products exception, and that federal preemption is therefore inappropriate. The argument collapses on itself. Yes, some states have enacted legislation, but the content and form of

those special rules vary in each enacting jurisdiction. The overlay of these recent enactments on the UCC itself creates a new dimension of complexity for all parties concerned--lenders, producers and buyers. It is counterproductive in interstate sales settings where the applicability and details of a given state's law may be in doubt.

More fundamentally, what the state legislative activity has produced is a substantial non-uniformity among the states on the respective rights and obligations of lenders and buyers of agricultural products. Allowing the states to continue this idiosyncratic tinkering with the UCC can only lead to chaotic uncertainty as to the controlling law. It is a disingenuous argument to suggest that a problem that arises from a provision of the Uniform Commercial Code should be left to non-uniform resolution by the states.

What these circumstances really indicate, we submit, is the need for a uniform national rule that fairly respects the needs of buyers of agricultural products. A uniform national rule is not likely to emerge from the states or from the UCC sponsors. Congress has not only the prerogative but the responsibility to supply the needed stability and consistency. This is especially true in the case of the agricultural markets for which Congress has already assured a substantial supervisory role.

Ultimately, the sole question presented by S. 2190 and the similar House bills is whether Congress should act to correct an inequitable and capricious state law rule that has inflicted millions of dollars of losses on purchasers of farm products. We certailny believe Congress should so act along the lines of S. 2190.

In sum, the issue for the Subcommittee is captured in two excerpts from the House hearings. When a lender who had lodged a claim against a livestock buyer was asked whether he had pursued the borrower himself, or the cosigner, the reported response was "No sir, because under the law it is easier to come after you." This is the farm products exception in its essence. As counterpoint, a livestock processor put it this way: "The meat industry is having enough trouble staying alive today without laboring under the contingent liability of the national farm debt."

Mr. Chairman, we encourge favorable action by this Subcommittee and the Congress to eliminate the farm products exception. Thank you for considering the views of the American Meat Institute. I will be happy to answer any questions.

Analysis of the Farm Products Exception, UCC-9-307(1), prepared for the American Meat Institute by Ralph J. Rohner--Nov. 1983

I. INTRODUCTION

A significant problem facing buyers of farm products--especially the buyers who are packers or processors of livestock, or marketing agencies,--is that the commercial law applicable in virtually all states generally allows the lending institution that has financed the producer's operations to pursue the farm products collateral for those loans into the hands of buyers in the ordinary course of business. This means that when a producer sells livestock or other farm products, but does not use the sale proceeds to repay the lender's loan, the lender may sue and recover the value of those goods from the buyer. To safeguard the lender's interest, in other words, the buyer may be forced to pay twice for the same goods.

As a result, this state-law rule frustrates the normal expectations of commercial buyers, and leaves the rights of farm products buyers out of line with the rights of all other marketplace buyers in the ordinary course of business.

This "farm products exception" deserves the Subcommittee's serious attention for a number of reasons:

1. That portion of the Uniform Commercial Code that presently protects the lenders instead of the buyers of farm products, i.e., the "farm products exception," is anomalous within the Uniform Commercial Code itself, and out of step with basic commerial law policies. Ordinary-course buyers of commercial inventory routinely take free and clear of security interests created by their sellers, as do buyers of other types of collateral such as negotiable instruments, securities, warehouse receipts and bills of lading. Only in the case of farm products is the otherwise dominant policy of encouraging the free flow of goods in commerce not maintained.

2. Recognizing the anomalous and capricious effect of the farm products exception, a number of courts and state legislatures have sought to modify its impact in various ways; while sometimes helpful to farm products buyers, these state law efforts are sporadic and inconsistent, and in fact create new legal uncertainties and impose new procedural burdens. These state initiatives, however, do confirm the suspect nature of the "farm products exception" itself.

3. The problem is exacerbated for buyers of livestock, because federal law (the Packers and Stockyards Act, as amended in 1976) requires cash buyers of livestock to pay for their purchases on the spot or within twenty-four hours after the sale transaction. This means that processors, meat packers and other livestock buyers (including producers buying from other producers) must part with their purchase money at a time and under circumstances

when it is simply impossible for them to protect themselves against undisclosed security interests. The buyers, in short, are compelled by federal law to be insurers for any lender who is not paid off promptly with the proceeds of the sale.

4. Preemption of state law appears to be the only practicable way to produce a fair and uniform rule for application in the increasingly multistate farm products markets. Uniform state legislation to change the farm products rule is not likely in the forseeable future, if ever. Meanwhile utterly inconsistent special rules are being enacted on a state-by-state basis. Preemption of state law is justifiable not only to achieve uniformity, but also to correct the imbalance created by the federal Packers and Stockyards Act. Such preemption, with respect to the state-law Uniform Commercial Code, would not be unprecedented.

The sections below develop each of these points at greater length. There are also attached to this testimony several appendices which summarize the existing state law (including recent state legislation farm products exclusion), and the court decision involving claims against buyers of farm products.

II. THE "FARM PRODUCTS EXCEPTION" IS AN ANOMALY IN COMMERCIAL LAW

A. General policy of buyer protection in the UCC

1. UCC provisions

The so-called farm products exception derives from the language of section 9-307(1) of the Uniform Commercial Code, which provides:

> A buyer in the ordinary course of business...other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

The general thrust of this provision is to insulate ordinary-course purchasers from the claims of prior secured parties, but the underscored language explicity denies that protection to buyers of farm products.

The isolated nature of the farm products rule is clear on a examination of other UCC provisions. Under UCC 9-306(2) a secured creditor waives its rights in any type of collateral if the creditor has authorized the debtor to sell or dispose of the goods, and such authorization to sell may arise from explicit contract language, "or otherwise." UCC 9-308 and 9-309 confirm that bonafide purchasers of chattel paper, negotiable instruments, securities, warehouse receipts and bills of lading may take free and clear of prior perfected security interests. Outside of the secured financing context, provisions in Articles 2, 3, and 7 of the UCC create broad bonafide purchaser protections for buyers of

goods, negotiable instruments and negotiable documents. See UCC sections 2-403, 3-305, and 7-502.

The farm products rule is therefore clearly an exception to the mainstream commercial policy of permitting buyers to take free of prior claims of ownership or security.

2. The purposes of bonafide purchaser protections

It is important to understand why, as a general policy, the UCC favors purchasers over prior claimants. The reasons are basically ones of fulfilling the expectations of the parties, and implementing good public policy.

a. Goods cannot move smoothly through commercial channels if each buyer must initiate an investigation of the origins of the goods and of his seller's authority to sell. The buyer's usual expectation is that goods offered for sale by a merchant are legitimately in the stream of commerce, and that a purchase transaction--once completed in the ordinary course of business--will not be overturned or challenged by earlier secured creditors.

b. Protection of bonafide purchasers is also justified on pragmatic grounds. The secured creditor has presumably investigated the debtor's creditworthiness, integrity and business competence, to determine the level of risk in the transaction. Indeed a lender's business routinely includes calculating and taking those kinds of risks. The lender is therefore in a better position to monitor the debtor's conduct, to police the collateral, and to assure that the proceeds from the debtor's sale of collateral are applied on the debt. Purchasers, on the other hand, are generally not in a position to appraise whether the debtor/seller is properly performing its obligations under financing arrangements with various lenders.

c. The UCC confirms this general policy of protecting buyers in a striking fashion. Once the collateral is sold, UCC 9-306(2) gives the original lender an automatic and continuing security interest in the proceeds of that sale. Thus, when a farmer or rancher sells his crop or livestock, receiving in exchange the buyer's check, note or other payment obligation, that payment obligation becomes subject to the original security interest and may be seized by the lender to satisfy the original debt. This right to proceeds is in a very real sense a trade-off for allowing the buyer to take the actual collateral free of the security interest. But in the case of farm products the effect of these rules is that the lender's security interest continues in both the original collateral and the proceeds. The farm products lender gets two bites at the apple.

B. The "farm exception" has never had clear theoretical or practical justification.

Against the general UCC policies for protection of buyers, just discussed, the "farm products exception" in UCC 9-307(1) stands as a unique rule that has never been adequately justified.

1. Origins of the farm products exclusion

Protection for lenders on farm products collateral was the prevailing caselaw rule prior to the official promulgation of the Uniform Commercial Code in the early 1950s. Thus it is not surprising that the draftsmen should adopt that dominant view into UCC 9-307(1).

But what were the underpinnings of this special rule for farm products that the UCC draftsmen adopted? The Official Comments to the UCC say nothing about it. The principal draftsman of Article 9 of the UCC, Professor Grant Gilmore, has said that the farm products exclusion exists "for reasons which are never precisely articulated." II G. Gilmore, Security Interests in Personal Property Section 26.10 (1965). The gist of the pre-UCC caselaw was that somehow the purchaser just did not seem to merit treatment as a bonafide purchaser, at least when evaluated against the desire of the lender to retain its security interest protection.

Perhaps the best explanation is suggested by Professor Gilmore, and it is that a "small country bank holding a small country mortgage" made a more instinctively appealing plaintiff than did large commercial lenders. This makes sense. The court holdings that developed the special farm products rule are largely from the late 1800s and the early decades of this century--times when the privately-owned, farm-community bank was thought to be indispensable to the area's economic progress and well-being.

It is doubtful that the "small country bank" syndrome offers any persuasive support for the farm products exclusion in the 1980s. Even the smallest banks--with the assistance of trade associations and federal and state supervisory agencies--have the capacity to operate sophisiticated lending programs. If the farm products rule was originally thought necessary to prevent bank failure and the loss of customer deposits and savings, federal and state deposit insurance programs virtually nullify and such risk. Moreover, with the initiation of government financed or government supported farm credit programs under the aegis of the Department of Agriculture, the federal government itself has become a major financer of farm operations and thus a major beneficiary of the farm products exception. It taxes credulity to justify a preferential rule for large government lending programs on the ground that those programs are essentially "small country banks."

2. Nothing in the nature of farm products financing justifies treatment different from inventory financing.

Distinctive treatment for farm products financers could more easily be justified if that kind of financing were significantly different from financing against inventory or receivables. But it seems impossible to find any substantial or consistent difference in the financing patterns.

-- Financers of both farm products and inventory rely on collateral which is necessarily left in the debtor's possession for growing, processing, feeding, storage, exhibition or manufacture. The lender's risk position is the same in either case.

-- The seasonal nature of some farm products collateral is little different than much seasonal inventory (which may in fact consist of processed farm products).

-- Farm products financers as a group seem to be at no particular disadvantage, when compared to inventory financers, in exercising day to day monitoring or supervision of their debtors' handling of the collateral, and assuring proper application of proceeds. Both types of collateral, and both types of debtors, have elements of unreliability.

-- Financers, debtors and purchasers come in all shapes and sizes, regardless of the type of collateral. There are small country banks, large farming conglomerates, Mom & Pop purchasers and commercial inventory, large government farm-credit institutions, and so on. There seems no basis for distinctions based on the size of the participants. Purchasers of farm products may be acting as brokers, users or processors; inventory buyers may be similarly categorized.

There is not even a clear and universal distinction between goods that are farm products and goods that are inventory. The same crop of livestock may be classified as farm products in one case but as inventory in another. The farm products exception operates only on collateral which, at the time of sale, is farm products as that term is defined in the Uniform Commercial Code. The definition lists crops, livestock and similar items, but imposes two additional specifications: (1) in the case of products of crops or livestock, they must still be in an "unmanufactured" state, and (2) in all cases, to be farm products, the goods must still be in the possession of a debtor engaged in farming operations. Any goods that fall outside this complex definition become "inventory" and so are not subject to the farm products exclusion. The definition indicates how shadowy is the dividing line between farm products and inventory. For example, one court found that where a rancher left livestock at a commercial feedlot and sold them from there, the livestock were "inventory" rather than farm products. Garden City PCA v. International Cattle Systems, 32 UCC Rep. 1207 (D. Kans. 1981).

The point is that there are no differences of significance between farm products and inventory--yet purchasers of inventory qualify for bonafide purchaser protection while buyers of farm products do not.

Probably the strongest factor sustaining the farm products exception is simply inertia. The rule was incorporated into the UCC based on older judicial precedents, and has not been changed on the statute books of most states. Over time, of course, a protective rule such as this garners staunch defenders among those who benefit from it. But self-interest based on the status quo is not necessarily fair.

C. Specific ways in which the farm products exclusion is anomalous within the Uniform Commercial Code.

The farm products exclusion is inconsistent with the UCC's general policy of protecting the expectations of ordinary-course buyers, as just described. The odd nature of the farm products rule is shown in a number of specific instances.

1. Normally, when inventory collateral is sold off, the financer's security interest shifts from those inventory items to their proceeds. The farm products financer obtains such an enforceable security interest in the proceeds of sale--the check note, or other payment instrument--which the financer can tract into the debtor's bank account if necessary. But by virture of the farm products exception, that financer also continues to have an effective interest in the goods themselves, despite their sale. Farm products lenders, in other words, have two forms of security, where other lenders have only one.

2. According to UCC 9-301(1)(c), the farm products financer loses to a buyer in the ordinary course of business if the financer's security interest is left unperfected. Perfection usually involves filing a notice in an office in the county where the debtor resides. Yet, as discussed in more detail in the next section, buyers often find it impossible to verify whether financing statements are on file or not, before finalizing their purchases. Thus the farm products rule may or may not operate in the lender's favor, depending not on any particular knowledge by the buyer, but rather on the technicalities of the lender's own paperwork.

3. As noted above, the farm products rule does not apply if the goods are classified as inventory. Whether a particular farm commodity qualifies for the special rule may then depend on whether the goods have in some sense been "manufactured," or on whether they are still in the "possession" of the farmer/debtor. These characteristics, which would shift a crop or herd of livestock from farm products to inventory, may be largely fortuitous. In other words, the financer may be unaware of, and have no control over, circumstances that change the character of

his collateral and no longer subject it to the farm products exclusion.

4. The only interests that are preserved through the farm products exclusion are formal security interests (virtually always held by professional lenders). Other kinds of prior ownership interests can readily be cut off by bonafide purchaser rules elsewhere in the UCC. For example, suppose a rancher buys cattle from a neighbor in exchange for a check that bounces. If in the meantime the rancher resells those cattle to an innocent purchaser, that purchaser takes free and clear of the neighbor's claim of ownership. UCC 2-403. It is difficult to justify protecting the purchaser against this kind of fraud but not against the rancher's failure to pay the bank. It is equally difficult to explain why the professional lender deserves protection but the neighbor does not.

5. Perhaps the most bizarre effect of the farm products exception is that is the lender's security interest survives the debtor's sale to an immediate buyer, then it survives as to all subsequent purchasers as well. Thus a livestock financer, for example, could sue not only the commission merchant to whom the cattle were sold directly, but also the slaughterhouse that purchased from the commission merchant, and the packing plant, processor or other distributor, that bought from the slaughterhouse. Theoretically, the lender could pursue his collateral all the way to the consumer's dinner table. This is clearly the effect of UCC 9-307(1), even though in those subsequent sales the goods are conventional inventory and no longer farm products. (In sales of inventory, the buyer takes free of security interests created by his immediate seller, but not free of earlier liens.) The farm products exception, in other words, frustrates the expectations not only of the first buyer but all buyers in the chain of distribution.

III. STATE-LAW DISAGREEMENT WITH THE FARM PRODUCTS EXCLUSION

Beyond the analytical weaknesses in the farm products exclusion, there has been substantial disenchantment expressed about it by courts, state legislatures, and UCC draftsmen.

A. Court holdings

Although protection for the farm products lender problem remains the majority rule based on UCC 9-307(1), a number of courts have found openings in the UCC through which the effects of that provision can be avoided.

The most common ground for judicial decisions in favor of the purchaser is that the lender somehow "authorized" the sale, thus relinquishing any continuing security interest in the farm products once they are sold. This notion derives from language in UCC 0-306(2), and the courts have read it as qualifying the farm products rule in 9-307(1). Typically, farm products lenders will

specify in their loan agreements with producers that collateral is not to be sold without the lender's permission and without accounting for proceeds. Those courts which have found in favor of buyers have emphasized that despite such contract language a "course of dealing" had developed between the lender and borrower in which the lender acquiesced in sales made without express permission.

Not all courts have agreed on the applicability of this "waiver" theory. Some, intent on protecting the lender's interest, find either that the lender never gave any implied authorization to sell, or that the express terms of the contract control over the parties' conduct. The minority line of cases recognized the importance of the actual conduct of lenders, debtors and buyers, rather than simply relying on the literal language of the farm products exception in the UCC. The waiver or "authorization" cases thus show that judges will sometimes be creative, and will not apply the farm products rule unthinkingly in situations where it produces unfair results. Professor Barkley Clark, in his treatise Secured Transactions Under the UCC, has recently noted that these cases "continue the swing of the pendulum in favor of bonafide purchasers in this area." These expressions of judicial conscience, however, are limited in number, and offer no long-term solution if the rights of the parties must be litigated in every case.

As noted earlier, other courts have found that the farm products financer may not recover from the purchaser for other reasons: either the lender's security interest was unperfected (as by an inadequate description of the collateral), or because the goods were no longer in the possession of a farmer and thus were "inventory" rather than farm products.

Together these cases confirm that the farm products exclusion is neither blindly applied nor universally approved in the courts.

B. A number of state legislatures have enacted statutes to ease the burden of the farm products exception on buyers.

Most of the security interest provisions of Article 9 of the Uniform Commercial Code have been enacted and retained in the form in which the draftsmen promulgated them. But the farm products exception has been the subject of direct or indirect modification in at least sixteen states. Most of these modifications have as their purpose to reduce the risk that farm products buyers may have to pay twice for the same goods, and thus to avoid the discriminatory effect of the farm products exception.

This state legislation is listed and summarized in an attachment to this testimony. The state laws fall into several distinct categories:

1. One state has repealed the farm products exception outright, leaving farm products collateral subject to the same rule as other inventory: i.e., ordinary-course buyers take free and clear of the lender's security interest. It is noteworthy that the state that flatly rejects the farm products rule is California, the nation's largest producer of agricultural commodities. Bills to repeal the farm products exception have been introduced in nine state legislatures in the past two years.

2. Another type of state law provision subjects the debtor to criminal prosecution if the debtor engages in misconduct such as selling collateral without accounting for the proceeds, or selling collateral to buyers not previously listed with the seller. The purpose of these criminal sanctions is to encourage the farm products producer to disclose the lender's involvement to the purchaser. The safe step for the purchaser is then to issue its payment check jointly to the seller and the lender, thus assuring that the lender realizes those proceeds.

3. Perhaps the most frequently used mechanism in these variant state laws is to require that the secured lender give specific notice of its lien to prospective purchasers in advance of sale, as a condition to the continuing validity of the lien against those purchasers. Here too the theory is that, with such notice, the purchaser will take steps to assure that the payment proceeds go to retire the seller's indebtedness to the lender.

4. A related technique in some states is to require the buyer to obtain from the seller a certificate which identifies any outstanding security interests. The buyer must then make payment jointly to the seller and lienholder. Unless the buyer receives such a certificate, and makes payment accordingly, buyer is subject to the lien.

5. A number of states in recent years have changed from county filing to central state filing for security interests in farm products. This limits the number of offices in which records must be checked to verify outstanding security interests, but those offices may still be hundreds of miles away from the point of sale, or in other states altogether.

6. Several states have shortened the statute of limitations applicable to the lender's action over against the purchaser. This reduces the contingent nature of the purchaser's liability to the lender, and may induce the lender to monitor the debtor/seller a bit more closely. But it does nothing to relieve buyers of the basic risk imposed by the farm products exception.

Together these state enactments suggest a growing concern in the state legislatures about the fairness of the farm products rule in UCC 9-307(1). Each of these approaches seeks to alleviate some of the risk for a purchaser who innocently buys farm products without immediately seeing to it that outstanding liens are satisfied. But together they represent only scattered and

uneven responses to the problem. for example, a buyer located in one of these states would still be subject to the full force of the farm products exception if it purchased goods at sites outside that state.

C. The Article 9 Review Committee Recommendations

In light of the more recent state legislative activity just described, it is worth noting that in 1970-71 there was a serious proposal to delete the farm products exception from the official Uniform Commercial Code. At that time the Permanent Editorial Board of the UCC had appointed a Review Committee to draft revisions of Article 9 of the Code. In a preliminary report, the Review Committee recommended that the farm products exception be eliminated, but in its Final Report in 1971 the Review Committee waffled. Noting the pre-Code origins of the rule, the Committee "questioned whether the pre-Code practice is still sound under modern conditions," but doubted that the states would ever agree on a uniform policy. The Committee therefore softened its recommendation to an "optional" one.

The Permanent Editorial Board deleted the Committee's optional recommendation, for reasons that are unexplained. In context, it is likely that the PEB simply wanted to avoid making such a schizophrenic optional recommendation on a point that was so controversial in the states. The PEB may also have been deferring to the desires of the federal government, whose farm credit agencies were frequently the lenders insisting on preservation of their security interests against purchasers.

IV. THE PARTICULAR DILEMMAS FOR LIVESTOCK PURCHASERS

The effect of the farm products exception is to force the purchasers of farm products to become either collecting agents on behalf of the lender, or guarantors of the debtor's honesty, or both. Purchasers, however, are in no position and have no skill or means to perform either function, and there seems little reason why they should have those responsibilities.

A. The impossiblity of verifying farm products liens

Commercial sales of farm products commonly take place through a variety of market forums--i.e., through auctioneers, commission merchants, stockyards, warehouses, feed lots, buying stations, sale yards, terminal markets, and the like. Sale locations have tended to shift from large terminal markets to points closer to the farmer's or rancher's operations. Deals are negotiated, struck and consummated quickly, in a setting where complete and reliable information about the seller's outstanding loans and security interests on particular lots of goods may not be immediately at hand.

In this setting, the buyer concerned about protection from possible future claims by the seller's financing institution has

some very limited options. The buyer may ask the seller about the existence of liens and the identity of the lienholder. If such information is provided, the purchaser may issue checks payable jointly to the seller and the lienholder, or may seek lien waivers from the lender. But the seller may be unreachable (for example if goods are being handled through brokers or agents); or a seller engaged in widespread farming or ranching operations may not have available the details of financing arrangements covering those specific goods; or the seller may simply misrepresent the true facts. This latter possibility is likely in cases where the seller intends to divert the proceeds, and it is in just these cases that the unpaid lender will later seek a second payment from the purchaser.

Alternatively, and theoretically, the purchaser may check the filed financing statements required of secured creditors under Article 9 of the UCC. Such financing statements, indexed in the name of the debtor, identify the lienholder and contain at least a summary description of the covered collateral. The very purpose of the UCC filings is to alert third parties about outstanding secured claims.

Ironically, however, the UCC filing system that is designed to prevent misrepresentation and secret liens is largely useless for that purpose in the farm products setting.

With filings generally located in the county of debtor's residence or where the crops are grown, the purchaser needs to ascertain the seller's name and the appropriate location. That seemingly simply information may be quite elusive, for sellers operate as sole proprietorships, partnerships, corporations (with subsidiaries and operating divisions), and through syndications; and they may operate as several different commercial entities simultaneously. The county, even the state, of "residence," or of crop location, may be problematic for widespread production enterprises. Even if a financing statement is found, it may reflect only a general description of collateral--such as "1983 wheat crop," or "beef cattle"--without further specification.

Not only is the public record information difficult to find and often imprecise, but distance and time constraints make the problem more acute. Buyers must often settle for purchases on the day of sale or shortly thereafter, while lien informaton is located in offices that are usually open only during normal business hours. Moreover, those filing offices are likely to be many miles away, or even in different states.

As a practical matter, therefore, farm products purchasers are often powerless to verify and respond to the risk of an undisclosed security interest. Yet the effect of the farm products exception is to force those purchasers to guarantee that payment by them will actually reach the (undisclosed) lienholder.

B. Effect of the "prompt payment" rule of the Packers & Stockyards Act

Purchasers of livestock (as distinct from other farm products) face a special problem that increases their dilemma. By virtue of Section 409 of the Packers and Stockyards Act, 7 U.S.C.A. Section 228b, cash purchasers of livestock must settle for their purchases by check or wire transfer before the end of the next business day after the purchase is made. That is, federal law requires final payment for the livestock within a time frame that is so short that it becomes virtually impossible to make inquiries of and receive responses from UCC filing offices that may be scattered through numerous states and counties. The purchased livestock itself is held "in trust" for the sellers until those payment checks clear.

This federal "prompt payment" rule was strengthened by statute in 1976, as part of an effort to protect livestock producers from the risk of non-payment. This had happened following the bankruptcy of several large meat packers whose checks for livestock purchases were then dishonored. Properly administered, the PSA prompt payment provision may serve a useful purpose, but its causal relationship to the problems arising from the farm products exception is clear. On the one hand federal law forces livestock buyers to pay promptly to the seller; on the other hand the farm products rule of the UCC forces them to pay again to the seller's financer if the seller misappropriates the original payment. This seems a clasic Catch-22 pattern.

There is an irony here as well. The prompt payment rule in section 409 of the Packers and Stockyards Act was created to deal with problems flowing from the collapse of meat packing and processing companies. The indirect effect of the PSA provision is to increase the risk that those packers and processors will have to pay twice for some livestock; this kind of risk can only contribute to the possibility of more meat packer failures.

V. PREEMPTION OF STATE LAW WITH RESPECT TO THE FARM PRODUCTS EXCEPTION SEEMS JUSTIFIED, AND IS NOT UNPRECEDENTED

A. Preemption is justified to deal with a problem of national scope where state law solutions are inadequate or uneven.

Present agricutural markets generally have relatively fewer (but larger) purchasers of agricultural products for processing and resale than in the past. This tends to blur state lines and create more national (or at least regional) markets for farm products. Differences in the state law applicable to farm products sales become obstacles to the smooth operation of these national and regional markets, and at such a point federal intervention and preemption may become necessary.

Just such a situation is occuring with respect to the farm products exception. What was once a uniform state rule protect-

ing the farm products lender is now being whittled away by numbers of state statutes and court opinions. Courts in some states continue to apply the farm products exception literally, while courts in other states are inclined to find that the lender has waived the lien by "authorizing" sales of the collateral.

A quarter of the states have acted legislatively to mitigate the farm products exception, imposing various requirements to help assure that farm products purchasers are not unduly burdened. But these approaches are inconsistent from state to state, and that inconsistency undercuts any utility those state innovations may have. Corrective action by one state does not even help its own residents when they purchase farm products elsewhere.

There is no realistic prospect that the Uniform Commercial Code will be amended to adjust the farm products exception at the state level. There are currently no plans for revising Article 9 of the UCC in this regard. Even if an official or "optional" amendment were recommended by the Permanent Editorial Board and the other UCC sponsors, there is little likelihood it would be adopted in uniform fashion throughout the country.

With respect to the Farmers Home Administration and other federal farm creditors, there is an especial reason why a federal statutory rule on bonafide purchaser rights is appropriate. Because of the federal government's interest in those lending programs, the courts have long agreed that the government's rights as a creditor are not controlled absolutely by state law and may be determined by courts as a matter of federal "common law." But in its decision in United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979), the Supreme Court ruled that governmental entities such as the Small Business Administration and the Farmers Home Administration would be bound, as a matter of federal common law, by non-discriminatory state law of general applicability. The effect is that the rights of the FmHA and similiar lenders are controlled by the Uniform Commercial Code. To the extent those rules begin to vary from state to state with divergent interpretations of the UCC, or with additional state statutory conditions, there is further justification for a standard, nationwide rule.

B. <u>There is an overriding justificaton for preemption in the case of buyers of livestock</u>.

Beyond the reasons just mentioned for federal preemption of the farm products rule, there is an additional consideration affecting buyers of livestock. This is the fact that part of the problem for livestock buyers is <u>caused</u> by federal law. The "prompt payment" provision in Section 409 of the Packers and Stockyards Act turns the screws several notches tighter for livestock purchasers, who must pay their sellers immediately, usually without opportunity to verify pre-existing liens. This federal

provision, intended to cure one difficulty, in fact created a new one.

Congress should acknowledge that its handiwork in 1976 has compounded the problem of livestock purchasers. A preemptive federal law abolishing the farm products exception would be the most appropriate response.

C. Preemption in this context has ample precedent.

If Congress were to preempt the farm products exception in the UCC, it would hardly be the first time federal law has displaced portions of the Uniform Commercial Code.

The most obvious precedent is in Section 410 of the Packers and Stockyards Act, 7 U.S.C.A. Section 228c, which specifically preempts state laws dealing with the bonding of packers and with prompt payment by packers for livestock purchases. The "trust" provision of the same federal law, Packers and Stockyards Act Section 206, effectively displaces those UCC provisions which some courts had held to deny sellers the right to reclaim the goods if the buyer's checks were dishonored.

Outside of the farm products area, there are numerous examples of federal laws that supersede portions of the Uniform Commercial Code. For example, security interests in ships, aircraft, and railroad rolling stock are subject to federal statutes with respect to perfection and priorities. The Federal Bills of Lading Act controls over Article 7 of the UCC for interstate carriers. Portions of the Magnuson-Moss Warranty Act limit the operation of rules in Article 2 of the UCC. The Federal Reserve Board's Regulation J applies to check collections through the Federal Reserve system, notwithstanding UCC Articles 3 and 4.

The list could be extended. The point is that Congress has not hesitated to act and to preempt even such deep-rooted state law as the UCC when there is justification for doing so.

D. Preemption of the farm products exceptin should not unduly disrupt farm credit operations.

If Congress were to abolish the farm products exception by federal statute, the immediate consequence is that farm products financers would no longer be able to throw off onto innocent purchasers the risk of loss when the producer fails to apply the sale proceeds on the debt. This, we submit, is just what the law should provide, in the interests of fairness and to prevent continuing discrimination against purchasers of farm products. Whether such a reallocation of risk would have any disruptive effect on the operations of farm lenders and producers in necessarily a matter of speculation.

A number of factors suggest that the impact of a preemptive federal law would be minimal. For one thing, some farm products

financers bear those risks already: there is no farm products exception in California, and court holdings in other states deny its use to lenders, though legally entitled to pursue the purchaser, do not do so for reasons of expediency (distance, likelihood of recovery, litigation expenses, etc.). So the amount of new risk is unclear.

For another, preemption of the farm products rule would not mean that purchasers could never be accountable. The buyer would still have to qualify as a "purchaser in the ordinary course of business." The buyer would have to be acting in good faith and without knowledge that the particular sale was unauthorized. These criteria would permit the lender to recover from any buyer who was a knowing participant in an unauthorized sale.

A reallocation of risk from buyers to lenders is also justifiable if the net amount of losses would be reduced, or if those losses could be absorbed more efficiently by lenders than purchasers. A case can be made for each of these suppositions. Losses from unauthorized sales and unaccounted-for proceeds now fall indiscriminately on buyers. That is, the loss occurs after the sale when a particular producer fails to pay off the secured loan with the sale proceeds. Buyers are powerless to predict in advance the transactions that will cause losses, and powerless to control the debtor/seller's use of the proceeds once the sale had been finalized. Lenders, on the other hand, generally maintain continuing relationships with the debtors, through which they can periodically check the status of the collateral or demand prompt accounting for collateral that has been sold. It is likely that lenders confronted with a new measure of risk of non-payment will minimize that risk through inexpensive, routinized policing techniques.

Further, lenders are inherently better positioned to absorb and distribute the resulting losses. For example, lenders can reflect actuarial projections of unauthorized-sale losses in their rate and fee structures for distribution among all borrowers. Or insurance against that specific form of risk may be feasible. Under the present law, by contrast, the losses fall fortuitously and randomly on purchasers of different sorts who as a group are much less likely to be able to absorb or distribute the losses through their customer base.

With a clearly preemptive federal rule, financers and producers would be spared the burden and expense of complying with the various recent state laws that impose extensive disclosure or certification duties on them.

Some may argue that at least a marginal increase in the cost of farm credit is inevitable if the farm products exception is preempted by federal law. This Subcommittee could usefully inquire into just that possibility. We doubt, however, that this Subcommittee or the Congress would find any measurable interference with farm products financing.

VI. CONCLUSION

In summary, the so-called farm products exception as it now exists in UCC 9-3007(1) is anomalous and inequitable. It casts a risk of loss on innocent purchasers that the UCC generally would impose on the lender as a cost of its business. It has the effect of making farm products buyers unwitting guarantors of the seller's honesty, while the buyers are powerless to protect themselves against that exposure. The farm-products exception is fragmenting in the courts and in state legislatures, in a way that makes uniform, preemptive federal law appropriate. Federal preemption is particularly fitting in the case of livestock purchasers because the federal Packers and Stockyards Act contributes to their dilemma. Finally, there is no basis to believe that a real location of this risk would seriously disrupt farm credit activities.

We appreciate the opportunity to present these views, and encourage the Subcommittee to take steps to solve this farm products problem. We note the two bills pending on this matter, H.R. 3296 and H.R. 3297, and hope the Subcommittee will pursue them.

Appendix A

The following are representative court cases which have dealt with the issue of a buyer of farm products in the ordinary course of business. Most resolutions have depended upon whether the sale was authorized. If the sale was authorized, the security interest ends in the collateral; if the sale was not authorized, the security interest countinues. The first two lists are cases that have been decided in this way. A third list presents cases which have found various other ways to resolve the problem.

I. Unauthorized Sale/Security Interest Continues:

1) In re San Juan Packers, Inc., 696 F2d 707 (9th Cir. 1983) (Sale of farmer's vegetable crop to a food processor was unauthorized. The perfected security interest in this crop had priority over a perfected interest in the food processor's inventory.)

2) In re Sunriver Farms, Inc., 27 Bankr. 655 (D. Ore. 1982) (The buyer entered a purchasing agreement to buy the farmer's bean crop. Later the farmer created a security interest in this crop. Since delivery had not been made to the buyer, title had not yet passed. The secured party had priority over the buyer. The subsequent completion of the sale was unauthorized since the security agreement required any purchases to be made by check to both the farmer and the secured party, and this was not done.)

3) Cox v. BancOklahoma Agri-Service Corp., 641 SW2d 400 (Tex. Ct. App. 1982) (The debtor was in the business of

buying, fattening, and selling cattle. The secured party knew of this business and did not protest the sales. After the court found the cattle to be farm products rather than inventory, it determined that this course of dealing did not authorize the sale to the buyer since the buyer was without knowledge of these prior dealing.)

4) United States v. Chesley's Sales, Inc., 523 F. Supp. 528 (W.D. Pa. 1981) (The sale of three cows by an auction firm was unauthorized since the security agreement required written consent and none was given.)

5) United States v. Riceland Foods, Inc., 504 F. Supp. 1258 (E.D. Ark. 1981) (An FmHA "borrowers list" omitted the debtor's name, but the buyer's reliance on this list did not authorize the sale.)

6) Benson County Cooperative Credit Union v. Central Livestock Assn., Inc., 300 NW 2nd 236 (N.D. 1980) (Remanded to determine if sale was authorized as a question of fact.)

7) Fisher v. First National Bank of Memphis, 584 SW 2nd 515 (Tex. Civ. App. 1979) (The secured party did not authorize a sale of cattle since a course of dealing will not control over an express provision in the security agreement against sales.)

8) Southwest Washington Production Credit Assn. v. Seatle First National Bank, 92 Wn2nd 30, 593 P2d 167 (Wash. 1979) (Sale of farmer's crop was unauthorized although there was a course of dealing over a period of years permitting sales without requiring written consent. The secured party had only consented to the sale on condition that he receive payment. Since he did not receive payment, the condition was not met and the sale unauthorized.)

9) Oxford Production Credit Assn. v. Dye, 368 So2d 241 (Miss. 1979) (Sale of farmer's cotton crop was unauthorized since the security agreement required written consent and no written consent was given.)

10) Mammoth Cave Production Credit Assn. v. Oldham, 569 SW2d 833 (Tenn. Ct. App. 1977) (Remanded to determine if sale was authorized as a question of fact.)

11) United States v. Smith, 22 Rep. 502 (N.D. Miss. 1977) (FmHA's security interest in a farmer's crops cannot be waived by any informal consent or waiver provision from the FmHA's county supervisor since any implied consent would exceed his authority.)

12) Production Credit Assn. v. Columbus Mills, 22 UCC Rep. 228 (Wis. Cir. Ct. 1977) (Unauthorized sale of farmer's corn crop.)

13) Wabasso State Bank v. Caldwell Packing Co. & Robel Beef Packers, 251 NW2d 321 (Minn. 1976) (The sale of cattle was unauthorized since the security agreement contained an express provision against sales.)

14) United States v. Topeka Livestock Auction, Inc., 392 F. Supp. 944 (N.D.Ind. 1975) (Auctioneer was held liable for conversion of a farmer's livestock since the FmHA did not authorize the sale.)

15) Colorado Bank & Trust Co. v. Western Slope Investment Inc., 539 P2d 501 (Colo. App. 1975) (A course of dealing could not operate to authorize a sale of cattle where a security agreement required written consent.)

16) Baker Production Credit Assn. v. Long Creek Meat Co., Inc., 513 P2d 1129 (Ore. 1973) (Sale of cattle was unauthorized, although the secured party consented to the sale, since a condition of sale was that a draft be made payable to the secured party, honored, and paid and this condition was not met.)

17) Farmers State Bank v. Edison Non-Stock Coop. Assn., 190 Neb. 789, 212 NW2d 625 (1973) (Where a financing statement permitted the debtor-farmer to sell farm products in the regular course of business unless he was in default, the sale of cotton was unauthorized when the debtor was in default.)

18) First National Bank of Atoka v. Calvin Pickle Co., 11 UCC Rep. 1245 (Okla. App. 1973) rev'd on other grounds, 516 P2d 265 (Okla. 1973) (Although the secured party permitted the farmer to sell crops and remit the proceeds, the sale of crops to the defendant was unauthorized since the security agreement required written consent.)

19) United States v. Hughes, 340 F. Supp. 539 (N.D. Miss. 1972) (The FmHA's security interest in a farmer's soybean crop continued despite the county supervisor's actions to permit debtors to market their grain.)

20) United States v. E.W. Savage & Son, Inc., 343 F. Supp. 123 (D.S.D. 1972), aff'd 475 F2d 305 (8th Cir. 1973) (The FmHA held a commission agent liable in conversion for the sale of cattle. The express prohibition against sales in the security agreement cannot be overcome by a course of dealing or otherwise.)

21) United States v. Pete Brown Enterprises, Inc., 328 F. Supp. 600 (N.D. Miss. 1971) (Purchaser of chickens was liable in conversion to the secured party.)

22) Garden City Production Credit Assn. v. Lannan, 186 Neb. 186 NW2d 99 (1971) (A course of dealing between the secured party and the debtor, by which the secured party had not objected to the A-5 rancher's prior sales of cattle and had accepted the proceeds did not operate as a waiver when the buyer did not know of the course of dealing and the security agreement required a written waiver.)

23) United States v. Basing, 7 UCC Rep. 1120 (E.D. Ill. 1970) (The FmHA held the operator of a grain mill liable for conversion of crops in which it held a security interest when the security agreement required written consent prior to the farmer's sale.)

24) Overland National Bank of Grand Island v. Aurora Cooperative Elevator Co., 184 Neb. 843 (1969) (Unauthorized sale of a farmer's milo crop.)

25) United States v. McCleskey Mills, Inc., 409 F2d 1216 (5th Cir. 1969) (The United States' security interest in a farmer's present crop continued despite its sale since the sale was unauthorized.)

26) Vermillion County Production Credit Assn. v. Izzard, 249 NE2d 352 (Ill. App. 1969) (The reference to proceeds in the security agreement and financing statement was insufficient to authorize as sale.)

27) Duvall-Wheeler Livestock Barn v. United States, 415 F2d 226 (5th Cir. 1969) (An auctioneer was liable in conversion for selling livestock subject to a security interest. This interest was not waived since the security agreement required written consent, which was not given, and there was no course of dealing to the contrary.)

28) United States v. Greenwich Mill & Elevator Co., 291 F. Supp. 609 (N.D. Ohio 1968) (The FmHA's security interest continued in a farmer's crops despite its agent's statements to the buyer concerning the crop's disposition.)

II. Authorized Sale/Security Interest Ends:

1) National Livestock Credit Corp. v. Schultz, 653 P2d 1243 (Okla. App. 1928) (The sale of cattle was authorized, despite a provision in the security agreement requiring joint payment to the seller and secured party, since

the secured party and the industry had established a course of dealing otherwise.)

2) First National Bank & Trust Co. of Oklahoma City v. Iowa Beef Processors, 626 F2d 764 (10th Cir. 1980) (The secured party had given its consent to the debtor to sell cattle and for payment to be made directly to the debtor. Its conditioning that the debtor submit the proceeds to the secured party did not condition its consent to the sale to the buyer since the buyer had no control over the payment once it was in the debtor's hands.)

3) Benson County Cooperative Credit Union v. Central Livestock Assn., Inc., 300 NW2d 236 (N.D. 1980)(Remanded to determine if sale was authorized as a question of fact.)

4) United States v. Lindsey, 455 F. Supp. 449 (N.D. Tex. 1978) (Although authorization could not be implied by acts of FmHA agents, express authorization had been given to the dairy farmer to sell "cull" cows for slaughter without obtaining prior consent.)

5) North Central Kansas Production Credit Assn. v. Washington Sales Co., 577 P2d 35 (Kan. 1978) (The expressed consent of an officer of the PCA, assuring the debtor that he could sell the cattle without prior written consent so long as the proceeds were applied to the loan, authorized the cattle's sale.)

6) Mammoth Cave Production Credit Ass'n v. Oldham, 569 SW2d 833 (Tenn. App. 1977) cert. denied by Tenn. S. Ct. (1977) (Remanded to determine if sale was authorized as a question of fact.)

7) Hendrick Savings Bank v. Myers, 229 NW2d 252 (Iowa, 1975) (The secured party's course of dealing, allowing sales of livestock on prior occasions and accepting checks from such sales, authorized this sale despite a prohibition in the security agreement.)

8) Planters Production Credit Ass'n v. Bowles, 256 Ark. 1063, 511 S.W. 2d 645 (1974) (Secured creditor authorized sales through course of dealing.)

9) Lisbon Bank & Trust Co. v. Murray, 12 UCC Rep. 356 (Iowa 1973) (The sale of cattle to the buyer was authorized through a course of dealing between the secured party and debtor since the security agreement did not require written consent.)

10) United States v. Central Livestock Assn., Inc., 349 F. Supp. 1033 (D.N.D. 1972) (The sale of cattle was

authorized by the FmHA by giving day-to-day permission to the debtor to sell and relying upon him to remit the proceeds. This was the resolution even through the security agreement required written consent.)

11) In re Cadwell, Martin Meat Co., 10 UCC Rep. 710 (E.D. Cal. 1970) (The course of dealing between the secured party and the debtor and the filing of a financial statement covering "proceeds" operated to authorize the sale to the buyer despite a requirement in the security agreement of written consent.)

12) Swift & Co. v. Jamestown National Bank, 426 F2d 1099 (7th Cir. 1970) (A cattle buyer in the business of buying, feeding, and selling cattle was authorized to make sales in his ordinary course of business by the terms of the security agreement.)

13) Clovis National Bank v. Thomas, 425 P2d 726 (N.M. 1967) (Secured party, by permitting the debtor to sell his cattle from time to time as the debtor chose, waived his right to require written authority prior to a sale as provided in the security agreement.)

III. Other Resolutions:

1) Farmers State Bank v. Webel, 113 Ill. App. 3d 87, 446 NE2d 525 (Ill. App. 1983) (Opinion modified on rehearsing) (Pigs were inventory, not farm products, in the hands of one who bought and sold them, only fattening the pigs while they remained unsold.)

2) Garden City Production Credit Assn. v. International Cattle Systems, 32 UCC Rep. 1207 (D. Kans. 1981) (The buyer took free of the secured party's security interest because the cattle were inventory for a feed-lot operation. Nor were the cattle in the possession of the debtor.)

3) Weisbart & Co. v. First National Bank of Delhart, Texas, 568 F2d 391 (5th Cir. 1978) (The secured party exercised its security interest and foreclosed prior to the completion of a sale.)

4) First National Bank of Atoka v. Calvin Pickle Co., 516 P2d 265 (Okla 1973) (The financing statement failed to describe the land upon which the crops were planted with the specificity required to perfect the secured party's security interest.)

5) United States v. Hext, 444 F2d 804 (5th Cir. 1971) (Since the debtor was both a cotton farmer and the owner of a gin mill, a purchase from the gin mill was a purchase

from the debtor but not from one engaged in farm operations.)

6) Bank of Madison v. Tri-County Livestock Auction Co., 9 UCC Rep. 53 (Ga. App. 1971) (The debtor's return of cattle to the seller after being unable to pay for them did not constitute a sale, so the secured party's security interest in the debtor's after-acquired cattle had priority.)

7) Swift & Co. v. Jamestown National Bank, 426 F2d 1099 (8th Cir. 1970) (The secured party's security interest was unperfected because the financing statement was filed in the wrong place.)

Appendix B

Sixteen states have enacted legislation that affects the "farm products exception" in Section 9-307(1) of the Uniform Commercial Code. Those states and the nature of their legislation are as follows.

1) Arkansas: (sec. 85-9-306(1)) A security interest in farm products will not be waived through any course of dealing or trade usage.

2) California: (Cal. Commercial Code sec. 9-307(1)) The exception has been deleted, giving the ordinary course buyer of farm products the same protection given to any other buyer in the ordinary course of business.

3) Delaware: (Del. Code, Tit. 6, sec. 9-307(1)) Creates a registry for grain buyers and affords any registered grain buyer the same protection as any other buyer in the ordinary course of business unless they are notified prior to the sale by the secured party.

4) Georgia: (Ga. Code, Tit. 109A sec. 9-307(3)) A commission merchant who sells farm products will ont be held liable to the secured party.

5) Illinois: (Del. Rev. Stat., Ch. 26, secs. 9-205, 9-306, 9-307) Requires disclosure to the secured creditor of anyone to whom debtor might wish to sell his farm products and penalties for selling to someone else. The buyer takes free of any security interest in the farm products unless given written notice of the security interest by the secured party within five years prior to the sale. Similar protection is given to a commission merchant.

6) Indiana: (Ind. Code sec. 26-1--9-307) The debtor must disclose to the secured party those buyers to whom he wishes to sell his farm products. The secured party

must give prior written notice to the buyer within eighteen months before a sale. The buyer who receives prior written notice must pay for the farm products by issuing a check jointly to the debtor and the secured party.

7) Kansas: (Kan. Stat. Ann., ch. 84, sec. 9-307(1)) Affords the buyer of milk, cream, and/or eggs the same protection as most buyers in the ordinary course of business.

8) Kentucky: (Den. Rev. Stat., ch. 355, sec. 9-307) Duly licensed tobacco warehouses, grain storage warehouses, stockyards, and race horse auctions take free of any security interest in the respective goods in which they deal unless the secured party gives them written notice of the interest. The secured party must also pursue a judgment against the debtor before he can commence an action against a purchaser or selling agent of livestock or grain.

9) Nebraska: (Neb. Rev. Stat. sec. 90-9-307) The buyer of farm products is required to ask the seller for the name of the first security interest holder and must issue a check to be paid jointly to the seller and this secured party. If the secured party authorizes the cashing of the check, the buyer takes free of any security interest.

10) New Mexico: (N.M. Stat. Ann. sec. 55-9-306(2)) Forbids a security interest to be waived through any course of dealing or trade usage.

11) North Dakota: (N.D. Cent. Code, sec. 41-09-28) The seller of farm products must disclose to the buyer of commission merchant any security interests on the goods or be subject to criminal charges. The buyer must also request this information and make a check payable to both the secured party and the seller. If this is done, the buyer or commission merchant takes free of the seurity interest. The secured party must pursue the debtor for any loss sustained before seeking redress from the buyer or commission merchant.

12) Ohio: (Ohio Rev. Code, Tit. 13, sec. 1309.26) A buyer in the ordinary course of business of farm products takes free of any security interest unless he receives written notice within 18 months prior to the sale and he fails to make payment jointly to the seller and secured party. The debtor is required to provide a list to the secured party of those buyers to whom he may sell.

13) Oklahoma: (Okla. Stat. Amn., Tit. 12A, sec. 9-30) The buyer of commission agent of farm products other than livestock, to take free of a security interest, must

require the seller to execute a document which discloses any security interests in the goods. The instrument for payment of the goods must be issued to the seller and any secured parties as joint payees.

14) Oregon: (Ore. Rev. Stat., Tit. 8, sec. 79.3070) Financing statements covering cattle, horses, or sheep must be filed with a central livestock department and shall subsequently be furnished to livestock auction markets, livestock dealers, and other livestock sales. If this statement is not filed, the security interest ends in the collateral upon disposition.

15) South Dakota: (S.D. Laws Ann., Tit. 57, sec. 9-307) The seller of farm products must disclose to the buyer or commission agent any security interests in the products or be guilty of fraud. The secured party must offer to file a complaint against the debtor before instituting an action against the buyer or commission agent.

16) Tennessee: (Tenn. Code Ann. sec. 47-9-30) A security interest in livestock or grain, tobacco, or soybean crops that are sold through commission merchants, meatpackers, or warehouses shall not continue unless written notice is given to these entities prior to the sale. If the secured party complies with this written notice requirement and still suffers loss, he must try to collect from the debtor before instituting suit against the commission merchants, meatpacker, or warehouse.

(The following letter was submitted by Professor Rohner subsequent to the hearing of September 26, 1984:)

Dear Senator Huddleston:

At the hearing on S. 2190 which you conducted on September 26, you asked the witnesses to address the form that any remedial legislation should take to afford protection to buyers of farm products. There were several suggestions that legislation modeled on the recent state "notification" laws might be the answer. In expressing AMI's support for your bill, I alluded to the fact that under S. 2190 creditors would be able to protect themselves in the same way they would under the state notification laws. This letter is to elaborate a bit on that point, for inclusion in the hearing record if possible.

If your bill were enacted as is, a buyer of farm products would take free of security interests only if the buyer qualified as a "buyer" in the "ordinary course of business." This is a term of art under the Uniform Commercial Code, and presumably would be defined the same way in a federal statute. It requires that the buyer be "without knowledge that the sale to him is in violation of the . . . security interest of a third party." Uniform Com-

mercial Code section 1-201(9) (definition of buyer) in the ordinary course of business). In other words, your bill would not operate as blanket protection for all buyers under all circumstances, but only for buyers who were unaware that it was an unauthorized sale.

It would certainly be possible for a secured creditor, in these circumstances, to take steps to notify possible buyers of the existence of the security interest, and to advise such prospective buyers that the sale requires the creditor's authorization. The notice might further state that authorization is given if the sale proceeds are remitted in the form of a joint-payee check or similar arrangement. Once the creditor gave such notice, the buyer would be protected from future claims only if he complies with the restriction.

Your bill does not require that creditors give notice in this fashion, but it clearly permits them to do so. The various state notification laws achieve essentially the same effect, but may impose very detailed requirements about the form, content and timing of the notice. Those requirements will inevitably vary from state to state. It is this feature of those state laws that gives us concern about a blizzard of paper, with conceivably endless haggling (and litigation) over whether the notification was technically correct and timely.

Your bill, as originally introduced, may in fact be a more streamlined way to encourage creditors to monitor their debtors' markets, to identify prospective buyers, and to give them specific notice of the conditions for an authorized sale. The only "legal" question would be whether the buyer had knowledge, and this is a question that, when necessary, the courts have handled satisfactorily for years under the UCC. Secured creditors, under your bill, would have maximum freedom to devise notification systems to suit their own needs and preferences, without the risk of imposing a new layer of intricate paperwork burdens.

Thank you for your continuing interest in this matter. AMI is anxious to work with your Subcommittee and all other interested groups to find the best possible solution to the problem S. 2190 addresses.

Sincerely,

Ralph J. Rohner
Professor of Law

PRELIMINARY REPORT OF THE TASK FORCE ON FARM PRODUCTS LEINS TO THE FARM CREDIT COUNCIL--SEPTEMBER 6, 1983

(Members of the Task Force: Ross Anderson, David Dewey, Earl Hoing, Don Meers, Steve Phelps, and Harve Phipps)

Introduction

Background

As a result of the depressed farm income situation of the past few years, agricultural production lenders and buyers of farm products have increasingly found themselves pitted against one another. Farm lenders have been placed in financial jeopardy because some of their borrowers have sold farm products pledged as collateral without applying the sales proceeds to their indebtedness. On the other hand, the realities of the marketplace have frustrated the best attempts of grain and livestock buyers to protect their interest in purchased farm products. Buyers have had to contend with the risk of paying twice for their purchases--once to the producer and again to the lender who held a security interest in the commodity they purchased. Simultaneously, under present law, a large number of potential lenders' claims for conversion are never asserted against the buyers of mortgaged commodities.

With growing concern over the lien issue, the "buyers' lobby" has become increasingly active in state legislatures, pressing for a change that would permit buyers of farm products to take free and clear of liens created by the seller. Such legislation has been introduced, but not enacted, in the legislatures of at least nine States since January 1982. To date, 13 States have passed legislation providing some relief for farm products.1/

At the national level, House Bills 3296 and 3297 were introduced on June 14, 1983, by Congressman Tom Harkin (D-IA). (Copies of these bills are included in Appendix C.) By Federal preemption, H.R. 3296 would effectively repeal the "farm products exception" to Section 9-307(1) of the Uniform Commercial Code (the "Code"). The "farm products exception" is the provision of the Code which enables farm lenders whose loans are secured by farm products to enforce their security interest as against the buyers of the commodities given as collateral. H.R. 3297 would amend the Packers and Stockyards Act to accomplish the same result with respect to livestock only.

Task Force

Given the heightened tenor of the debate at the Federal level and recognizing the diversity of views among members of The Farm Credit Council and their constituencies, a Task Force on Farm Products Liens was appointed to assist in developing a recommend-

NOTE: Footnotes at end of statement.

ed position for The Farm Credit Council. The six-member Task Force is comprised of three attorneys and three credit officers. FICB and FLB representatives were designated by the chairmen of the respective Loan Services Committees. BC representatives were designated by the chairmen of the BC Capitol and Credit Committee.

In the course of its work, the Task Force received input of Farm Credit Bank attorneys and/or credit staff in every Farm Credit district which include States that have recently addressed the issue. Nonetheless, this paper is the product of the Task Force alone. The charge of the Task Force was not to set policy but to facilitate discussion of the issue among the Council members; to review and comment upon recent action on the issue across the country; and to recommend a position to The Farm Credit Council.

Issues

Since its adoption, the so-called "farm products exception" contained in Section 9-307(1) of the Code has been the subject of considerable litigation and voluminous law review articles. The Permanent Editorial Board of the Code considered but rejected a proposal to delete the farm products exception as a part of comprehensive uniform amendments recommended in 1972.

Discussion on the merits of the farm products exception has nonetheless continued among various agricultural groups. Key issues that have been identified are:

-- The ability of buyers of agricultural products to adequately protect themselves against double payment.

-- The impact of any change in the law on lenders' risk.

-- Who should bear the risks caused by those producers who do not apply proceeds from the sale of collateral toward repayment of their secured indebtedness.

-- The cost of reducing or eliminating the problem and who should (or will) bear such costs.

-- The availability and/or cost of credit to producers (including most young and beginning farmers) who must rely on farm products as primary collateral to secure their loans.

Overriding these issues is the ability of producers, lenders, and buyers to work together toward a mutually satisfactory solution.

The Farm Productions "Exception"

Exception to the Exception

Property, both real and personal, is generally sold subject to the unreleased liens created by the seller. Under Artilcle 9 of the Code (adopted in 49 States), an exception is made for "goods sold in the ordinary course of business." These goods, such as a retailer's inventories, are sold free of security interests, or liens, created by the seller, e.g., the retailer.

Yet, as originally drafted and adopted in 49 of the 50 States,2/ the Code provides an "exception to the exception" in the case of farm products. Section 9-307(1) of the Code provides:

> "A buyer in ordinary course of business . . . other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." (Emphasis supplied.)

The underscored language is referred to as the "farm products exception." It is the target of the buyers' frustration.

The general thrust of Section 9-307(1) is to protect buyers against liens created by the sellers of goods sold in the ordinary course of business. Thus, as a general rule, the buyer of goods need not bother to search courthouse or centrally filed records for liens against the property being purchased.

Yet, by virtue of the farm products exception, buyers of farm products must search for liens or bear the risk of having to pay twice for their purchase if a lien exists: once to the seller and again to the secured lender of the proceeds from the sale of the collateral are not applied toward the seller's indebtedness. In this respect, farm products are uniquely treated among goods sold in the ordinary course of business.

Historical Background

For a century the courts and some legislatures resisted business debtors' use of inventory as collateral. This was partly because of conceptual difficulties, but also for the sound policy reason that one who buys foods held out for sale should not have to worry about security interests created by his seller. Most farm products would be looked upon as the farmer's inventory were it not for their classification as "farm products" under the Uniform Commercial Code.3/ Nevertheless, the special treatment accorded farm products under Section 9-307(1) is not of recent vintage. Rather, the farm products exception represents a codification of the pre-Code common law rule which has been characterized by no less an authority than Grant Gilmore as "so firmly established (prior to the advent of the Code) that defendants...

no longer even argue the point."4/ Referring to a 1931 Nebraska Supreme Court decision which conformed the law of Nebraska to, in the court's words, that of "practically all other jurisdictions," Professor Gilmore added "and there can be no doubt that this was so."5/ Thus, the farm products exception to Section 9-307(1) represents not only the collective wisdom of the 49 State legislatures that originally enacted the Code, but also the overwhelming weight of pre-Code judicial opinion.

Rationale

The logic and rationale underlying the farm products exception, which treats "farm products" differently than other types of inventory collateral, must be carefully reviewed. The special treatment accorded farm products under Section 9-307(1) stems from a fundamental difference between crops and livestock, on the one hand, and nonfarm commercial inventory, on the other hand. Most commercial inventory is sold "off the shelf" on a continuous basis and oftentimes to countless, relatively unsophisticated and unidentified consumers. Proceeds generally are not applied to the loan, but are reinvested in replacement inventory. By contrast, farm products are sold to comparatively fewer buyers, clearly identified to the seller. More importantly, farm products are more often sold "in bulk."

Here the biological production, once this year's crop is marketed, there is no replacement crop to maintain the lender's collateral position. Proceeds are not reinvested in a "replacement crop" but are generally applied to retire the secured loan. Thus, if the producer fails to apply the sales proceeds from his crop to his production loan, the lender will very likely find itself in a seriously undersecured, if not totally unsecured, position, even though the lender has done everything required under the law to perfect its security interest and put third parties on notice that the crop is encumbered. More importantly, the lender will have lost not only its collateral but the primary, if not the exclusive, source for repayment of the loan.

Yet, despite the fact that farm products are very often sold "in bulk," sales of farm products are not subject to the creditor protections afforded other inventory lenders in Article 6 of the Code, the so-called "bulk sales" provisions. Nor would the inclusion of farm products in the Code's bulk sales provisions be appropriate, inasmuch as farm products--unlike true "bulk sales" as defined in Article 6--are sold in bulk in the ordinary course of business.

Limited Scope

In assessing the impact of Section 9-307(1) as it presently stands in most States, it is important to understand the scope of the farm products exception. The Official Comment to Section 9-307 puts the matter this way:

"The limitations which this Section imposes on the persons who may take free of a security interest apply . . . only to unauthorized sales by the debtor. If the secured party has authorized the sale in the security agreement or otherwise, the buyer takes free without regard to the limitations of this Section." (Comment 2 to Section 9-307 (emphasis supplied).)

Thus, the protection afforded agricultural lenders under Section 9-307(1), and therefore the risk exposure to grain and livestock buyers, is considerably narrower than is generally assumed. For instance, if the secured lender has consented to the sale of collateral, either expressly or impliedly, the buyer takes free of the security interest--even in the case of farm products.6/ Yet, it is precisely in that small percentage of cases where the farm products exception does come into play--namely, where the debtor has made an unauthorized sale of collateral and failed to apply the proceeds to his indebtedness--that the protection afforded lenders by the farm products exception is so crucial. Without it or some other form of protection not now present in the law of most States, the availability of short- and intermediate-term credit for many small, beginning, and marginal farmers and ranchers would suffer, and the cost of production credit to virtually all farmers and ranchers would increase commensurate with the increased risk incurred by lenders.

Problems Under The Current Law

The farm products exception is a provision of the Code which favors availability of credit to agricultural producers. It recognizes the unique nature of farm products as to their biological production, their marketing custom, as well as their key role as a basis for extension of credit. Nonetheless, as a practical matter, buyers of farm products and even lenders face real problems in operating under the farm products exception and related notice provisions of the Code. In part, these problems are due to changes in the industry and the environment in which buyers, lenders, and producers must transact business. Each of these groups is impacted by those changes.

Environmental Factors

Changing nature of the agricultural production scene. Greater production, increased ability to transport both grains and livestock greater distances, more off-farm grain sales, increased use of operating leases, and other structural changes have created an economic environment different from that of the 1930s or 1960s. Many farm and ranch businesses have become more complex than the sole proprietorship more common to agriculture in the past. Frequently production units operate under two or three forms of business entity (e.g., John Smith, John and Joe Smith Partnership, John Smith Farms, Inc.). As a result, a review of liens recorded in local filing offices of computer checks from central filing locations will not eliminate entirely the risk of buying from an individual under a name other than that of the

debtor which incurred the debt to finance the production. Indirectly, this problem impacts the lender in that, if diversion occurs, it is difficult to trace farm products through the seller.

Increasing farm debt. The farm sector has used increasing levels of debt over time, both in absolute and relative terms. As of December 31, 1982, nonreal estate farm debt reached $105 billion. Farmers' debt-to-asset ratio increased to 20.1% and farmers' debt-to-equity ratio reached 25.1%. Increases in leverage in a period of lower levels of real net farm income have increased the debt servicing problems of many borrowers. Frequently, this increased leverage is created by producers increasing their debt from sources other than the production lender. This increases the risk of diversion of collateral proceeds and underscores the need for adequate protection for both the buyer and lender.

Marketing farm products. Markets have become more concentrated due to changes in technology. Livestock packers are now few, with very large plants. Livestock may be moved hundreds of miles from the location of production to the slaughter plant. Transportation patterns and economics relative to grain marketing have also changed. Grain may now be moved to more terminal markets for shipment to export locations. In both livestock and grain marketing, buyers now serve many more sellers, decreasing the ability of the buyer to have personal knowledge of the seller's financial arrangements or financial position. For the same reason, it is more difficult for lenders to identify potential buyers in order to control and track their security.

Operating Problems

Environmental factors, as well as operational realities of marketing farm products, give rise to a number of operating problems under the farm products exception and related notice provisions of the Code as enacted in most States.

1. In most States, financing statements to perfect security interests in farm products are filed locally, i.e., in the county where the debtor resides and, in the case of crops, also in the county where the crops are grown. With farm products commonly moving directly from the farm to terminal markets and frequently out of the county, there are countless places where buyers must check for liens in order to protect their interest in the commodity.

2. Lien information is sometimes incomplete. It is not always accurate and is difficult to match with specifically named sellers or a given lot of fungible farm products.

    a. It is frequently difficult to determine ownership of farm products because multiple individuals and/or entities may be involved in ownership of the commodities.

This poses problems for lenders in tracing their collateral as well as for buyers in determining to whom payment should be made.

b. Oftentimes, filing office records may not reflect the true status of liens because some lienholders, anticipating future financing, may not release liens after satisfaction of the debt. Checks made jointly payable to lienholders in such cases may create ill will among buyers, sellers, and lenders.

c. Grains and oil seeds and, to a lesser extent, livestock are largely homogeneous products that cannot be identified in a similar fashion as equipment with an identification number or real estate with a legal description.

3. The time frame within which to thoroughly check the financing statement records is short. Federal and State public warehousing laws require warehouses to accept grain for storage and sale, yet grain dealer laws in many States require prompt payment for grain. Under the federal Packers and Stockyards Act, buyers are required to pay for livestock before the close of the next business day following the purchase.

4. Lien information is only available during normal business hours, while many livestock markets operate during the nonworking hours of most offices.

Alternatives Considered

In recent years, buyer groups, often working with lenders and farm organizations, have surfaced a number of alternatives to address operating problems associated with the farm products exception and related notice provisions of the Code.

Repeal of the Farm Products Exception

This was accomplished in California, effective in 1976. Legislation to strike the farm products exception to Section 9-307(1) has been introduced but not enacted in a number of other States7/ and is currently pending in Congress. This solution is attractive to some as a "quick fix" to the problem: it could be easily and cleanly implemented. Among the alternatives identified, it is the one that could most easily be accomplished at the Federal level to achieve uniformity among the States.8/ This solution would treat farm products on a par with all other goods sold in the ordinary course of business. Thus, it would disregard the unique nature of farm products among goods sold in the ordinary course of business. Accordingly, this alternative is strongly opposed by the farm lending community. Having extended credit on the strength of a self-liquidating lien, the lender would be stripped of an important means by which to police its collateral as well as its principal source of repayment.

Buyers would have no incentive to assist in assuring that collateral proceeds are applied to the underlying indebtedness. Accordingly, by some degree the cost of agricultural credit would be increased and/or the availability of such credit would diminish.

Central Filing for Farm Products Liens

This alternative has been adopted in Iowa and Kansas, among other States. North Dakota has recently enacted legislation that contemplates a shift to a central filing system for farm products liens. In Oregon, security interests in farm products are perfected by filing centrally with the Secretary of State; however, security interests in livestock are valid as against buyers only if also filed with the Department of Agriculture.

The central filing solution leaves intact the unique treatment of farm products among goods sold in the ordinary course of business. Thus, it maintains the long established balance of responsibility between lenders and buyers of farm products. This solution recognizes that buyers' operating problems are largely problems of notice and attempts to deal with the notice problem by establishing within each State a single office at which all farm products liens must be filed.

Yet, critics of this solution point out that it is only a partial solution and is not easily implemented.

— Problems of identifying the true owners of farm products remain.

— Timing problems. Buyers (especially livestock buyers) would still have difficulties unless the central filing location in each State (presumably the Secretary of State's office) had its records computerized with 24-hour telephone access.

— Even if computerized, computers search for exact information. Even minor errors in spelling of descriptions could frustrate accurate reporting of existing liens.

— Most States do not now have central filing for farm products collateral, and the costs associated with establishing and maintaining a computerized central filing system are considerable.

— Central filing leaves with the buyer the burden of checking the records or buying at his peril.

Lien Disclosure Certificates

This approach was adopted by State Legislatures in Nebraska, North Dakota, Oklahoma, and South Dakota in 1983. Though details vary among the States, generally these laws require the buyer to obtain from the seller a certificate of ownership in which the

seller certifies as to the condition of title to and specifically identifies any security interests outstanding against the commodity. If there is a lien, the buyer, is obliged to make payment jointly to the seller and the lienholder. The buyer will take the commodity subject to any outstanding lien unless he can produce the seller's certificate and demonstrate that the prescribed procedures were followed. In North Dakota, those procedures include an obligation to search for liens in the home county of the seller where the certificate reveals no liens.

The certificate approach is attractive because it imposes a burden on producers who, as a group, are primarily responsible for the problem. In addition to informing buyers of outstanding liens, the certification process at the moment of sale draws to the seller's attention the importance of satisfying the lien.

Still, this alternative is no ironclad protection against sellers who would give a false certificate and divert the proceeds. This alternative imposes a significant administrative burden on buyers to obtain certificates in connection with every transaction or assume the financial risk of paying twice for purchased farm commodities.

Actual Notice

The States of Delaware, Illinois, Indiana, Kentucky, Ohio, and Tennessee have adopted similar laws which permit buyers to take farm products free and clear of liens except where they have received actual written notice of the lien by certified mail prior to the sale.9/ In addition, the laws of Illinois, Indiana, and Ohio authorize secured lenders to require that borrowers disclose to them, prior to sale, the parties to whom the producer intends to sell or otherwise dispose of farm products given a security. Sales to undisclosed buyers are subject to criminal penalties.

The actual notice alternative establishes a method of notification that permits the buyer to act confidently to protect his interest. It leaves the lender a tool by which he can police collateral and the application of collateral proceeds. Under this alternative the lender and buyer share responsibilty for policing collateral, but the burden of inadequate information shifts to the lender who is more likely to have superior information as to the seller's business and financial condition. But, just as buyers can never be certain where grain or livestock originated, neither can lenders be certain as to whom the grain or livestock will be sold. Thus, the lender cannot be certain of where he must give notice.

Shorten the Statute of Limitations

In several States, concerned parties have suggested that buyers' problems could be lessened by legislation which would require lenders to pursue promptly their claims against buyers or lose the claim.10/ By reducing the period of time available to

lenders to make their claim, the buyers' exposure to contingent liabilities is likewise reduced. From the lenders' standpoint, in many instances considerable time may have elapsed before the diversion is discovered and traced to the buyer. Still, the major financial risk of diverted proceeds would rest with the buyer.

Other Solutions

Under a new South Dakota statue, a secured lenders can file suit against the buyer of farm products only after having initiated criminal action against the seller.

The laws enacted in a number of States, including Illinois, Indiana, North Dakota, Ohio, Oklahoma, and South Dakota, impose criminal sanctions on sellers who provide fraudulent information or otherwise defraud the lender. By doing so, these States recognize the need to fix responsibility to both the buyer and the lender without which neither can adequately protect his interest in the commodity.

Task Force Observations and Recommendations

Observations

Having reviewed a number of options proposed and adopted in various States, the Task Force noted the following:

1. Farm products are produced to be sold in the ordinary course of the producer's business.

2. Typically, the biological production of farm products is financed with loans for which those same products serve as both primary security and the principal source of repayment.

3. It is in the interest of all segments of the industry to ensure that the farm products lien is satisfied. Accordingly, all segments of the industry, including producers, buyers, and lenders, should share reponsibilty for ensuring that the lien is satisfied.

4. Most producers pay their debts; but when economic hardship "pushes them to the wall," some producers attempt to gain additional time by diverting proceeds form the sale of collateral and thus breaking the law.

5. Too much of the debate has focused on buyers and lenders while overlooking producers, a small minority of whose fraudulent actions give rise to the problem. Abuse by a small minority of producers creates costs that are borne by the entire industry--producers, lenders, and buyers. In effect, producers who abuse the system increase the cost of doing business for other producers. The vast majority of

producers who meet their obligations must be educated to this business reality.

6. Without some discipline to ensure parties' rights are respected, no trade custom will function effectively. Yet, neither can the trade custom function if the parties have no practical means to assure themselves of knowledge sufficient to protect their interest in the transaction.

7. The status quo is not considered acceptable by many buyer groups: there is a real operating problem and there is little indication the problem will diminish without some legislative change.

8. The concerns of lenders, should the farm products exception be repealed, are no less real. Their interest must also be protected. The economic climate and the realities of agricultural finance, in the environment of 1983, require a legislative alternative other than repeal of the farm products exception to Section 9-307(1).

9. The issue arises under provisions of the Uniform Commercial Code adopted at the State level and should, therefore, be resolved at the State level with active participation of all segments of the industry. The wisdom of addressing the problem at the State level with active participation of all segments of the industry. The wisdom of addressing the problem at the State level is demonstrated by the fact that State legislatures are considering the issue at a rapid pace.11/ Although there is merit in uniformity among the States, the problem should not be dealt with through Federal intervention. Rather, efforts should be directed toward recommending solutions to the individual States. This approach recognizes the principle of States' rights, as well as the significant differences in agricultural practices across this diverse nation.

10. Significant criminal penalties should be enacted and aggressively imposed on those producers who abuse the process and thereby serve as a deterrent to others who might be tempted to divert proceeds from the sale of collateral.

11. Any proposed solution should avoid developing an unnecessary bureaucracy or impeding unnecessarily the free flow of goods in the channels of commerce. In addition, any solution should be cost-effective since producers and consumers ultimately bear the cost of the current problem, as well as the cost of a solution.

Recommendation

The Task Force recommends that The Farm Credit Council and each District Farm Credit Council adopt the following Statement of Position:

Farm Products Liens

The availability of farm production loans at reasonable cost is crucial to a healthy agricultural and national economy. Typically, the biological production of farm products is financed with loans for which those same products serve as both primary security and the principal source of repayment. The importance of farm products security as a key factor in the loan decision is recognized in the farm products exception to Section 9-307(1) of the Uniform Commercial Code, which would otherwide permit sale of farm products free and clear of liens.

The Farm Credit Council strongly opposes legislation whose effect would be the mere elimination of the farm products exception. In adopting this position, the Council recognizes that, as enacted in most States, Section 9-307(1) and the notice provisions of the Code do not, as a practical matter, assure potential buyers notice of outstanding liens sufficient to enable them to protect their interest in purchased farm commodities.

The issue arises under provisions of the Uniform Commercial Code adopted at the State level. Accordingly, the Council will support and will seek to facilitate solutions at the State level consistent with the following principles:

-- It is in the interest of all segments of the industry to ensure that the farm products lien is satisfied.

-- All segments of the industry, including producers, buyers, and lenders, should therefore share responsibility for ensuring that the lien is satisfied.

-- Those who divert collateral proceeds or otherwise abuse the process should suffer stiff criminal penalties.

Footnotes

1/ See Appendix A and B.

2/ Louisiana has not enacted Article 9 of the UCC, which contains Section 9-307(1).

3/ Section 9-109(3) of the Uniform Commercial Code defines "farm products" as:

> "crops or livestock or supplies used or produced in farming operations or . . . products of crops or livestock in their unmanufactured states . . . if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations."

Thus, although crops and livestock are included in the definition of "farm products" so long as they remain in the possession of the farmer, other types of farm collateral, such as

equipment used in farming operations, do not fall within the scope of the farm products exception to Section 9-307(1).

4/ II Gilmore, Security Interests in Personal Property, Section 26.10, at 708 (1965).

5/ Id.

6/ As a further illustration of this point, it is noteworthy that most of the litigation between lenders and buyers concerning the farm products exception has centered around the issue of implied consent to the sale, with the courts demonstrating an increasing willingness to find such implied authorization in the secured lender's course of conduct. So much so that Professor Barkley Clark in his treatise on secured transactions referred to a recent case as "continu(ing) the swing of the pendulum in favor of bona fide purchasers in this area." Clark, The Law of Secured Transactions Under the Uniform Commercial Code, paragraph 8.4(4)(b) at S.8-6 (Cum. Supp. 1983). Thus, not only is the scope of the farm products exception much narrower than has widely been thought, but the courts have increasingly sought to protect grain and livestock buyers from the prospect of having to pay twice for their purchases.

7/ See Appendix A.

8/ However, the Task Force strongly believes that to impose this or any other solution at the federal level by preempting the provisions of the Uniform Commercial Code, and thereby remove from the various state legislatures the opportunity to address the issue, would create a disturbing precedent of congressional intrusion into an area more appropriately, and historically, left to the states.

9/ Louisiana has recently enacted legislation which provides that the owner or operator of a market agency is not liable to any person holding a security device affecting livestock sold through the agency on a commission or consignment basis unless the owner or operator has received written notice of the security device.

10/ Iowa, Nebraska, and South Dakota have recently shortened their statutes of limitations to two years, 18 months, and 1 year respectively.

11/ See Appendix A and B.

CURRENT STATUS OF FARM PRODUCTS EXCEPTION TO UCC 9-307(1)
(As of August 24, 1983)

	No Change in Farm Products Exception	Farm Products Exception Repealed	Actual Notice[1]	Lien Disclosure Certificate[2]	Criminal Penalties[3]	Central Filing[4]	Legislation Introduced/ Not Enacted (1982-83)
Alabama	X						X
Alaska	X						
Arizona	X						
Arkansas	X						X
California		X				X[5]	
Colorado	X						
Connecticut	X					X	
Delaware	X[6]		X[6]			X	
District of Columbia	X					N/A	
Florida	X						
Georgia	X[7]						X
Hawaii	X					X	

[1]Secured party must give actual notice to the buyer in order to preserve its security interest.

[2]Buyer must obtain a statement from the seller identifying existing lienholders, if any.

[3]Where checked, state law includes criminal penalties for seller's misrepresentations as to existing liens and/or for failure to remit collateral proceeds.

[4]Security interests in farm products are perfected by filing with a central statewide office, e.g., Secretary of State.

[5]Local filing with respect to growing crops.

[6]No change with respect to livestock; actual notice limited to "any grain crop."

[7]Commission merchants are protected from liability under UCC 9-307(3).

CURRENT STATUS OF FARM PRODUCTS EXCEPTION TO UCC 9-307(1)
(As of August 24, 1983)

	No Change in Farm Products Exception	Farm Products Exception Repealed	Actual Notice[1]	Lien Disclosure Certificate[2]	Criminal Penalties[3]	Central Filing[4]	Legislation Introduced/ Not Enacted (1982-83)
Idaho	X						
Illinois			X[8]		X		
Indiana			X[8]		X		
Iowa	X					X	
Kansas	X					X[9]	
Kentucky			X				
Louisiana[10]							
Maine	X					X[11]	
Maryland	X						
Massachusetts	X						
Michigan	X						X
Minnesota	X						
Mississippi	X					X	

[8]Secured party may require debtor to furnish a list of potential buyers.

[9]Central filing to be phased in over a five-year period.

[10]Louisiana has not enacted Article 9 of the UCC, which contains Section 9-307. However, the owner or operator of a market agency in Louisiana is not liable to any person holding a security device affecting livestock sold through the agency on a commission or consignment basis unless the owner or operator has received written notice of the security device.

[11]Local filing with respect to growing crops.

CURRENT STATUS OF FARM PRODUCTS EXCEPTION TO UCC 9-307(1)
(As of August 24, 1983)

	No Change in Farm Products Exception	Farm Products Exception Repealed	Actual Notice[1]	Lien Disclosure Certificate[2]	Criminal Penalties[3]	Central Filing[4]	Legislation Introduced/ Not Enacted (1982-83)
Missouri	X						X
Montana	X						X
Nebraska				X[12]			
Nevada	X					X[13]	
New Hampshire	X						
New Jersey	X						
New Mexico	X						
New York	X						
North Carolina	X						X
North Dakota				X	X	X[14]	
Ohio			X[15]		X		
Oklahoma	X[16]			X[16]	X		
Oregon	X[17]					X[17]	

[12]Provision sunsets September 1, 1987.

[13]Local filing with respect to growing crops.

[14]Central filing is planned but not yet adopted.

[15]Secured party may require debtor to furnish a list of potential buyers.

[16]No change with respect to livestock; lien disclosure certificate limited to farm products other than livestock.

[17]Security interests in farm products are perfected by filing centrally with the Secretary of State; however, security interests in livestock are valid as against livestock buyers, their agents, and livestock auction market operators only if also filed with the Department of Agriculture.

CURRENT STATUS OF FARM PRODUCTS EXCEPTION TO UCC 9-307(1)
(As of August 24, 1983)

	No Change in Farm Products Exception	Farm Products Exception Repealed	Actual Notice[1]	Lien Disclosure Certificate[2]	Criminal Penalties[3]	Central Filing[4]	Legislation Introduced/ Not Enacted (1982-83)
Pennsylvania	X						
Rhode Island	X						
South Carolina	X						X
South Dakota	X[18]			X[19]	X[19]	X	
Tennessee			X				
Texas	X						X
Utah	X					X	
Vermont	X						
Virginia	X					X[20]	
Washington	X					X	
West Virginia	X						
Wisconsin	X						
Wyoming	X						

[18]Secured party cannot take civil action against a buyer unless secured party has first signed a criminal complaint against the seller.

[19]Seller must notify buyer of existing liens prior to sale; failure to do so constitutes a misdemeanor.

[20]Central filing with respect to grain only.

APPENDIX "B"

CURRENT STATUS OF STATE LEGISLATION AFFECTING
THE FARM PRODUCTS EXCEPTION TO UCC 9-307(1)

As of August 24, 1983, thirteen States had amended or enacted legislation affecting the "farm products exception" to Section 9-307(1) of the Uniform Commercial Code. Those States and their respective statues are set forth below.

1. California-"(Protection of buyers of goods.) (1) A buyer in ordinary course of business (subdivision (9) of Section 1201) takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." Sec. 9307.

2. Delaware-"(2) (A) Notwithstanding subsection (1) of this section (9-307), if any grain crop (which shall mean corn, wheat, barley, oats, soybeans or milo) subject to the lien of a security interest created by the seller of such grain is sold to any person which is a buyer in the ordinary course of business for value and which is registered with the Secretary of State as a registered grain buyer, before September 1, 1983 or at the time that the security interest is perfected, such person shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail, of such lien, the name and address of the seller/debtor and reasonable description of the property subject to the lien is mailed to the registered grain buyer purchasing said grian within one (1) year prior to the payment of the proceeds to the seller of such grain.

   (B) For the purpose of this subsection, the Secretary of State shall provide a registry, to be known as the Grain Buyer's Registry, whereby any person may register as a registered grain buyer. Registration shall require the complete and current name and mailing address of the person so registering. The Secretary of State shall make available to any person upon request a certified copy of the names and addresses contained in the registry.

   (C) The Secretary of State is authorized to make such regulations as are necessary to implement this subsection, including the imposition of reasonable fees for any person so registering."

3. Georgia-"Protection of buyers of goods--Commission merchants. (1) A buyer in ordinary course of business (subsection (9) of Code Section 11-1-201) other than a person buying farm products engaged in farming operations takes free of a security interest created by his seller

even though the security interest is perfected and even though the buyer knows of its existence . . . .

(3) A commission merchant who shall sell livestock or agricultural products for another for a fee or commission shall not be liable to the holder of a security interest created by the seller of such livestock or products even though the security interest is perfected where the sale is made in ordinary course of business and without knowledge of the perfected security interest." Sec. 11-9-307.

4. Illinois- "A secured party may require that the debtor include as part of the security agreement a list of persons to whom the debtor desires to sell or otherwise dispose of the collateral. The debtor shall not sell or otherwise dispose of the collateral to a person not included in that list unless the debtor has notified the secured party of his desire to sell or otherwise dispose of the collateral to such person at least seven days prior to the sale or other disposition." Sec. 9-205.1.

"Debtor disposing of collateral and failing to pay secured party amount due under security agreement; penalties for violation. (1) It is unlawful for a debtor under the terms of a security agreement (a) who has no right of sale or other disposition of the collateral or (b) who has a right of sale or other disposition of the collateral and is to account to the secured party for the proceeds of any sale or otherwise dipose of the collateral and willfully and wrongfully to fail to pay the security agreement. Failure to pay such proceeds to the secured party within ten days after the sale or other diposition of the collateral is prima facia evidence of a willful and wanton failure to pay.

(2) An individual convicted of a violation of this Section shall be guilty of a Class 3 felony.

(3) A corporation convicted of a violation of this Section shall be guilty of a business offense and shall be fined not less than two thousand dollars nor more than ten thousand dollars.

(4) In the event the debtor under the terms of a security agreement is a corporation or a patnership, any officer, director, manager, or managerial agent of the debtor who violates this Section shall be guilty of a Class 3 felony." Sec. 9-306.01.

"(1) Where pursuant to Section 9-205.1 a secured party has required that before the debtor sells or otherwise disposes of collateral in the debtor's possession he disclose to the secured party the persons to whom he desires to sell or otherwise dispose of such collateral, it is unlawful for

the debtor to sell or otherwise dispose of the collateral to a person so disclosed to the secured party.

(2) An individual convicted of a violation of this Section shall be guilty of a Class A misdemeanor.

(3) A corporation convicted of a violation of this Section shall be guilty of a business offense and shall be fined not less than $2,000 nor more than $10,000.

(4) In the event the debtor under the terms of a security agreement is a corporation or a partnership, any officer, director, manager or managerial agent of the debtor who violates this Section or causes the debtor to violate this Section shall be guilty of a Class A misdemeanor.

(5) It is an affirmative defense to a prosecution for the violation of this Section that the debtor has paid to the secured party the proceeds from the sale or other disposition of the collateral within ten days after such sale or diposition." Sec. 9-306.02.

"Protection of Buyers of Goods. (1) Except as provided in subsection (4), a buyer in the ordinary course of business, as defined in subsection (9) of Section 1-201, takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence . . . .

(4) A person buying farm products in the ordinary course of business from a person engaged in farming operations takes free of a security interest created by the seller even though the security interest is perfected unless, within five years prior to the purchase, the secured party has given written notice of his security interest to the buyer, sent by registered or certified mail. Such notice shall contain the name and address of the seller, a statement generally identifying the farm products subject to the security interest, and an address of the secured party from which information concerning the security interest may be obtained." Sec. 9-307.

"A commission merchant or selling agent who sells livestock or other farm products for others shall not be liable to the holder of a security interest in such livestock or other farm products, even though the security interest is perfected, unless within five years prior to the sale, the secured party has given written notice of his security interest to such merchant or agent sent by registered or certified mail. Such notice shall contain the name and address of the seller, a statement generally identifying the farm products subject to the security interest, and an address of the secured party from which information concerning the security interest may be obtained." Sec. 9-307.1.

"A commission merchant or selling agent who sells farm products for others and any person buying farm products in the ordinary course of business from a person engaged in farming operations shall post at each licensed location where said merchant, agent or person buying farm products in the ordinary course of business does business a notice which shall read as follows:

'NOTICE TO SELLERS OF FARM PRODUCTS

It is a criminal offense to sell farm products subject to a security interest without making payment to the secured party. You should notify the purchaser if there is a security interest in the farm products you are selling.'

Such notice shall be posted in a conspicuous manner and shall be in contrasting type, large enough to be read from a distance of ten feet." Sec. 9-307.2.

5. Indiana - "Protection of buyers of goods. (1) A buyer in ordinary course of business (IC 26-1-1-201 (9)) takes free of a security interest created by his seller even though the buyer knows of its existence. The following apply whenever a person is buying farm products from a person engaged in farming operations who has created a security interest on the farm products:

(a) A person buying farm products from a person engaged in farming operations is not protected by this subsection if he has received prior written notice of the security interest. 'Written notice' means notice on a form prescribed by the Secretary of State and containing the following:

(i) The full name and address of the debtor.
(ii) The full name and address of the secured party.
(iii) A description of the collateral.
(iv) The date and location of the filing of the security interest.
(v) The date and signature of the secured party.
(vi) The date and signature of the debtor.

A notice expires eighteen (18) months after the date the secured party signs the notice or at the time the debt appears on the notice is satisfied, whichever occurs first. Notice must be received before a buyer of farm products has made full payment to the person engaged in farming operations for the farm products if the notice is to be considered 'prior to written notice'.

(b) A secured party must within fifteen (15) days of the satisfaction of the debt inform a buyer in writing whenever a debt has been satisfied and written notice, as required by subdivision (a), had been previously sent to that buyer.

(c) A debtor engaged in farming operations who has created a security interest in farm products must provide the secured party with a written list of potential buyers of the farm products at the time the debt is incurred if such a list is requested by the secured party. The debtor may not sell farm products to a buyer who does not appear on the list (if the list is requested by the secured party) unless the secured party has given prior written permission to the debtor to sell to someone who does not appear on the list, or the debtor satisfies the debt for that secured party on the farm products he sells within fifteen (15) days of the date of sale. A debtor who knowingly or intentionally sells to a buyer who does not appear on the list (if the list is requested by the secured party) and who does not meet one (1) of the above exceptions, commits a Class C misdemeanor. A secured party commits a Class C infraction if he knowingly or intentionally gives false information on the notice required by subdivision (a) or he fails within fifteen (15) days of satisfaction of the debt to notify purchasers to whom notice had been previously sent (under subdivision (a)) of the satisfaction of the debt.

(d) A purchaser of farm products buying from a person engaged in farming operations must issue a check for payment jointly to the debtor and those secured parties from whom he has received prior written notice of a security interest as provided for in subdivision (a). A purchaser of farm products (on which there is a perfected security interest) buying from a person engaged in farming operations who withholds all or part of the proceeds of the sale from the seller, in order to satisfy a prior debt ('prior debt' does not include the costs of marketing the farm product or the cost of transporting the farm product to the market) owed by the seller to the buyer, commits a Class C infraction." Sec. 9-307.

6. Kentucky - "Protection of buyers of goods. (1) A buyer in ordinary course of business (subsection (9) of KRS 355.1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the buyer knows of its existence.

(2) If any tobacco crop subject to the lien of a security interest is sold at public auction through a duly licensed tobacco warehouse in the ordinary course of business, a bona fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouseman selling such tobacco crop shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail of such lien, the name and address of the debtor and proper description of the property subject to lien, are given to

the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop.

(3) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current grain storage license issued by the Commonwealth of Kentucky or a current Federal warehouse storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail, of such lien, the name and address of the debtor and proper description of the property subject to the lien is given to the entity purchasing said crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(4) If any livestock subject to the lien of a security interest is sold at public auction through a stockyard licensed by the Commonwealth of Kentucky in the ordinary course of business, a bone fide purchaser for value of such livestock shall take title thereto free and clear of any such lien, and the stockyard and selling agents selling such livestock shall not be liable to the holder of such lien, unless written notice by certified mail, return receipt requested or by registered mail of such lien, the name and address of the debtor and proper description of the livestock subject to lien is given to the stockyard prior to the time of sale . . . .

(6) If any registered breed of horse, the racing of which is regulated by KRS Chapter 230, subject to the lien of a security interest is sold at public auction in the ordinary course of business by an organization engaged in the business of selling such horses at public auction, a bona fide purchaser for value of such horse shall take title thereto free and clear of any such lien, and the organization selling such horse shall not be liable to the holder of such lien, unless written notice by registered mail of such lien and the amount thereof, the name and address of the debtor and proper identification of the horse subject to lien are given to the organization prior to the time of sale." Sec. 355.9-307.

7. Nebraska - "Protection of buyers of goods. (1) A buyer in ordinary course of business (subsection (9) of section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his or her seller even though the security interest is perfected and even though the buyer knows of its existence . . . .

(4) A buyer who purchases farm products or a person who sells farm products for another for a fee or commission shall require that the seller identify the first security interest holder with regard to the farm products being sold. If such seller is then paid the total purchase price by means of a check payable to such seller and the named first security interest holder and if the named first security interest holder authorizes the cashing of such check, the buyer of such farm products so purchased shall take free of any security interest. Any endorsement for payment made on such check shall not serve to establish or alter in any way security interest priorities under Nebraska law.

(5) Subsection (4) of this section shall terminate on September 1, 1987. In 1986 the Executive Board of the legislature shall designate an appropriate committee of the Legislature to review the operation of subsection (4) of this section. The committee shall conduct such review and may propose legislation to amend or postpone the termination date of subsection (4) of this section if the committee deems such action appropriate." Sec. 9-307.

8. North Dakota - "Protection of buyers of goods. 1. A buyer in ordinary course of business (subsection 9 of section 41-01-11) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence . . . .

4. Before a merchant who purchases or a commission merchant who sells farm products for another for a fee or commission issues a check or draft to the seller in payment for farm products, the merchant must require the seller to execute a certificate of ownership, on the form as prescribed by the commissioner of agriculture, disclosing the names, social security numbers, addresses and home counties of the owners for five years prior thereto, the county of location of the property prior to the sale, and the names of the parties to whom security interests have been given against the farm products or representing that security interests do not exist. The merchant is required to enter on the check or draft the name of the secured party disclosed in the certificate or actually known by the merchant at the time, as payee with the seller. The certificate must include a warning to the seller that an untrue statement as to any portion of the certificate constitutes a class C felony if the value of the property exceeds five hundred dollars, or a class A misdemeanor of the property does not exceed five hundred dollars in value.

5. A lender who relies upon a security interest shall advise the borrower at the time of (sic) the loan is made

that the law requires the borrower to disclose to the purchasers or merchants of the collateral the names of the secured parties, and that the purchasers or commission merchants are required to enter the names of the secured parties of the check or draft issued in payment for the farm products, and that failure to make the disclosure will constitute a crime.

6. A lender shall make a good faith effort against the borrower of funds, where farm products are used as collateral, for collection of any loss sustained by the lender through the transaction before the lender pursues collection from the merchant.

7. A merchant who purchases from or a commission merchant who sells farm products for another for a fee or commission takes free of security interest created by the seller if:

a. The merchant has complied with the requirements of subsection 4 of this section, and

b. In the case where the seller disclosed no security interests, the merchant has requested information from the register of deeds in the counties of the sellers' residences over the five years prior thereto, as disclosed in the certificate, (or from the office of Secretary of State if section 41-09-40 provides for filing in that office) as to the existence of financing statements naming the seller, and has recieved from the filing officer a certificate verifying disclosures obtained by such inquiry, and has entered on the check or draft the names of any secured parties named in the certificate as payees with the seller, and

c. The merchant does not have actual knowledge at the time of transaction of the existence of security interests, and

d. The merchant maintains records of such actions to support any criminal proceedings against the seller for violation of section 12.1-23-08.

8. In order to comply with the provisions of subsection 7, inquiry need not be made of the register of deeds office one year after the effective date of the Act which provides for filing in the office of the Secretary of State and the priority of filing of such documents will be based on the original filing date with the register of deeds." Sec. 41-09-28.

9. Ohio - "(B) The provisions of divisions (B)(1) to (8) of this section apply to persons engaged in farming operations and to persons buying farm products from persons engaged in farming operations.

(1) A buyer in ordinary course of business, as defined in division (I) of Section 1301.01 of the Revised Code, of farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence, unless both of the following apply:

(a) Within eighteen months prior to making payment to the person engaged in farming operations, the person buying farm products has received written notice complying with division (B)(2) of this section:

(b) The buyer fails to make payment for the farm products jointly, or otherwise in compliance with the instructions contained in such written notice, to the debtor and each notifying secured party.

(2) A written notice containing all of the following information is sufficient to comply with division (B)(1) of this section:

(a) The full name and address of the debtor;

(b) The name and address of the secured party:

(c) A description of the farm products with respect to which a security interest is claimed;

(d) The date and the signature of the secured party;

(e) The secured party's, and the debtor's if the notice is signed by the debtor, instruction that the buyer make payment for the farm products jointly to the debtor and the secured party or other reasonable payment instructions;

(f) Either a copy of the written agreement under which the debtor has authorized the secured party to request joint payment, or other payment instructions, or the date and signature of the debtor.

(3) A buyer who is (sic) good faith complies with a secured party notice received within eighteen months prior to making payment under division (B) of this section shall not be liable to the debtor for such compliance.

(4) A debtor engaged in farming operations shall provide, if requested by the secured party, written list of its potential buyers of the farm products. Without the prior written consent of the secured party, the debtor shall not sell farm products to a buyer who does not appear on the list. The debtor may amend the list by a written notice received by the secured party not less than fifteen days

prior to the debtor's sale of farm products to any person included by the amendment.

(5) For the purpose of divisions (B)(1) to (8) of this section, a buyer of farm products includes buying or selling agent.

(6) No buyer of farm products shall post publicly or otherwise disseminate to any person, other than its agents and employees, the name of any debtor identified in a notice under divisions (B)(1) to (8) of this section.

(7) Nothing contained in divisions (B)(1) to (8) of this section affects perfection or nonperfection of a security interest under sections 1309.01 to 1309.50 of the Revised Code.

(8) Any debtor who sells farm products in violation of division (B)(4) of this section is guilty of a misdemeanor of the first degree."

10. Oklahoma - "Protection of buyers goods. (1) A buyer in the ordinary course of business other than a person buying livestock from a person engaged in farming or ranching operations, hereinafter referred to as the seller for the purposes of this section, takes free of a security interest created by the seller even though the buyer knows of its existence.

(3)(a) Before issuing an instrument in payment for farm products other than livestock, a merchant purchasing such products from a seller or a commission merchant selling such products as an agent for a seller shall require said seller to execute a certificate disclosing the names of all lenders, if any, to whom security interests have been given in such farm products. If no such security interests exist, the certificate shall so state. The certificate shall include a warning that any false statement as to the identity of the lenders is a felony and is punishable by imprisonment in the state penitentiary for a period not to exceed three years or in the county jail for a period not to exceed one (1) year, or by a fine not to exceed Five Hundred Dollars ($500.00).

The certificate shall be substantially in the following form: (form omitted)

(b) The merchant shall enter the names of the lenders disclosed in the certificate on the instrument in payment for the farm products as joint payees. The endorsement of said lenders and the seller shall be required to negotiate said instrument. The instrument shall be issued as the net purchase price for payment for the farm products.

(c) Any false statement as to the identity of the lenders shall be deemed to be a violation of Section 1834 of Title 21 of the Oklahoma Statues.

(d) The merchant shall retain the certificate for a period of at least three (3) years. Such certificates shall be made available to such lenders during the regular business hours of such merchant.

(e) Any merchant purchasing farm products other than livestock from a seller, or selling such farm products for a fee or commission for a seller, who does not comply with the provisions of this section is liable to the secured party for any loss sustained by such party from the sale of the farm products when payment is made by the merchant to the seller. In such situation, the merchant takes the farm products subject to any perfected security interest which may exist in such farm products." Sec. 9-307.

11. Oregon - "(Liability of purchasers of livestock.) (1) In addition to the requirements of ORS chapter 79 regarding the filing of security interest financing statements, continuation statements, termination statements, statements of assignment, statements of partial release and statements of release, a person who obtains, maintains or terminates a security interest in cattle, horses or sheep situated in this State may also file copies of any such statements with the department. The provisions of ORS shapter 79 apply to the filing of statements under this section as those provisions relate to the form and content of the statements, the duration of the statements and the times for filing the statements.

. . . .

"(3) Upon receiving a statement and filing fee, the department shall index the statement according to the name and trade name, if any, of the debtor. If the cattle, horses or sheep described in the statement are marked with a brand recorded by the department, the department shall also cross-index the statement in the brand records of the department.

. . . .

"(5) Upon request the department periodically shall furnish to the livestock auction markets licensed under this chapter and livestock dealers bonded under the provisions of the Federal Packers and Stockyards Act of 1921, 7 U.S.C. Sections 181 to 228, as amended, the indexed information regarding the filings of effective financing statements and any statements of assignment. Department brand inspectors shall also furnish this information at sales of cattle, horses or sheep at locations other than licensed livestock

auction markets by notations on brand inspection certificates or other appropriate means. The department and its employees are not liable to debtors, secured parties, livestock sales operators or agents or other persons for administration of this section except as provided in ORS 30.260 to 30.300.

(6) Unless security interest statements have been filed as provided in this section, livestock auction market operators, purchasers of livestock and their agents are not liable to any secured party for proceeds from the sale of cattle, horses or sheep in which the party has a security interest."

12. South Dakota - "57A-9-503.1. No cause of action for recovery of security or its value may be commenced by a secured creditor against an innocent third-party purchaser of farm products as defined in subsection (3) of Section 57A-9-109, nor may such a cause of action be commenced against a livestock auction agency, as defined in Chapter 40-15, or a public grain warehouse, or a public terminal grain warehouse, or a grain dealer as defined by Chapters 49-43, 49-44 and 49-45 respectively, unless such action is commenced within twenty-four months from the date the farm products are sold and unless such action is preceded by the secured creditor offering to file against the debtor, a complaint as defined by Section 23A-2-1.

Section 2. That chapter 57A-9 be amended by adding thereto a new section to read as follows:

Any person who for himself, or through an agent, sells livestock through a livestock auction agency, as defined in Chapter 40-15, or who so sells grain through a public warehouse, or through a public terminal grain warehouse, or through a public terminal grain warehouse, or a grain dealer as defined in Chapters 49-43, 49-44 and 49-45 respectively, without notifying the livestock auction agency or the grain warehouse or grain dealer of a security interest in such farm products, and with intent to defraud, is guilty of farm products fraud. The failure of the seller to give written notice of a security interest in the farm products prior to the date of the sale by the livestock auction agency, or the grain warehouse, or grain dealer, is prima facia evidence of intent to defraud.

A violation of this section is a class one misdemeanor."

13. Tennessee - "Protection of buyers of goods. (1) A buyer in ordinary course of business (subsection (9) of Sec. 47-1-201) takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

(2)(a) If any livestock subject to the lien of a security interest is sold at public auction through a public livestock market chartered in this State or through a buying station, community sale yard, or meatpacker licensed by the State of Tennessee in the ordinary course of business, a bona fide purchaser for value of such livestock shall take title thereto free and clear of any such lien, and the public livestock shall take title thereto free and clear of any such lien, and public livestock market, buying station, community sale yard, or meatpacker and selling agent selling such livestock shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to such public livestock market, buying station, community sale yard, or meatpacker prior to the time of the sale.

(b) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current public grain warehouse license issued by the State of Tennessee or a current Federal warehouse storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lein, and shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the entity purchasing such crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(c) If any tobacco crop subject to the lien of a security interest is sold at public auction through a tobacco warehouse pursuant to Tennessee Code Annotated, Title 43, Chapter 19, in the ordinary course of business, a bone fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouse selling such tobacco crop shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop.

(d) The actual written notice required by Sections (2)(a), (b), and (c) may be satisfied when posted in the United States mail and verified by records maintained by the creditor. Said notice may be given for each individual debtor or provided in a list. The required notice must be given to the parties due same that are located in any county lying within a radius of seventy-five (75) miles of the principal office of the creditor. Such notices or lists shall be renewed annually. Said actual notice shall include the individual name of the debtor, the address of the debtor, and the proper description of the property subject to the lien and the location of the property subject to the lien as of the date the lien is perfected.

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(e) In the event a lien is perfected by the creditor in compliance with the procedures set forth in this section, the creditor shall not be permitted to seek recovery from a public livestock market, buying station, community sale yard, meatpacker, public grain warehouse, or tobacco warehouse unless such creditor has attempted by reasonable collection actions that said creditor has against the debtor-owner of said property." Sec. 47-9-307.

(The following letters were submitted by Mr. Thomas H. Olson:)

Independent Bankers
Association of America
Washington, D.C. 20036

June 21, 1984

The Honorable C.T. Conover
Comptroller of the Currency
490 L'Enfant Plaza East, S.W.
Sixth Floor
Washington, D.C. 20219

Dear Mr. Conover:

Last Wednesday, June 13, we held a full-day meeting of IBAA's Agriculture Committee in Omaha, Nebraska, in which 20 agricultural bankers from 12 states participated. Based upon the firsthand reports of these bankers, it is clear that any direction which your agency headquarters is giving to your loan examiners to exercise restraint in the classification of agricultural credits as problem loans is not getting down to the examiners level. Those bankers meeting in Omaha reported that they could detect no evidence of change toward a more accommodating stance by the examiners.

Two aspects of loan classification practices were singled out as particularly troublesome by the bankers. First, the examiners continue to classify loans in problem categories based upon cash flow even where the collateral securing the loan is more than adequate. For example, one $600,000 credit was classified "substandard" even though the bank involved remained well capitalized and even though that loan was secured by stock valued at $850,000 in a solid midwestern company. Although such instances often involve a substandard rather than a doubtful or nonperforming classification, when a bank finds a number of well-collateralized loans classified it makes it very difficult for the bank to forebear from taking adverse action in these cases even where thin farmland markets and other factors dictate against liquidating actions from a good management perspective.

Secondly, several bankers reported that it is virtually impossible, short of liquidation, to get a problem loan classification removed once it is instituted, regardless of the progress that is subsequently made on the loan. This would seem to be another reason to be cautious in the initial classification, as well as to have efficient procedures for reexamination of classified loans to remove a substandard classification when no longer warranted.

Please be assured that we do not wish to affect the examination process in a manner that might hamper the examiners in doing their job as provided by law. However, for the sake of equity, similar restraint must be exercised in the supervision of agricultural banks as is being exercised regarding the nation's largest banks as regards foreign lending--even though the direction of the bank examiner network may be more complex with regard to the largest number of agricultural banks. Furthermore, given the fragile financial and asset-value situation in domestic agriculture today, it is vitally important to understand that the morale of loan officers and their patience and forebearance can be severely affected by what they view as undue classification of loans within the bank's portfolio.

Sincerely,

Kenneth A. Guenther
Executive Director

Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

July 12, 1984

Mr. Kenneth A. Guenther
Executive Director
Independent Bankers Association
of America
1625 Massachusetts Avenue, N.W.
Suite 202
Washington, D.C. 20036

Dear Mr. Guenther:

Your letter expressed concern that examiners are not exercising restraint in the classification of assets in agricultural banks. Specifically, you indicate that examiners do not give sufficient emphasis to a bank's collateral position when evaluating loan quality and that once a loan is classified it is difficult to get the classification removed.

Enclosed are copies of two articles we have sent to all examining personnel. In addition, we have recently released guidelines for

the review and classification of agricultural loans. These issuances have served to heighten examiner sensitivity to the troubled conditions facing the agricultural economy. They have also served to promote better understanding of the OCC's position and to ensure that examiners are being objective and prudent in applying credit standards to agricultural loans.

The OCC's primary responsibility is to promote the safety and soundness of the national banking system. This responsibility is largely dependent upon the examination process; and, the review and classification of loans and other assets is an integral element of that process. These examination procedures ensure that asset deficiencies and weaknesses are brought to the attention of both OCC officials and bank management.

Significant loans are evaluated at each examination in conjunction with the evaluation of the overall condition of the bank. The degree of risk and likelihood of orderly liquidation in credits is evaluated, including analysis of any changes in the borrower's condition and prospects.

Loans may be classified for different reasons, but classification indicates they are not adequately protected by the current net worth and paying capacity of the borrower. Failure to generate sufficient cash flow to service term debt is a well defined weakness that jeopardizes the orderly liquidation of the debt and, in most cases, merits classification.

Sound banking practice precludes undue reliance on secondary sources of repayment, such as collateral, to liquidate debt. The support provided by collateral, however, strengthens a credit; and, the quality and marketability of the collateral are factors that are considered in the valuation of the credit.

Let me assure you that examiners have no incentive to force bank officials to take actions which are contrary to the best interest of their customers and institutions. While we continue to uphold traditional credit standards, examiners support well reasoned work-out plans. We recognize that decisions involving loan customers are properly those of their bankers.

Sincerely,

C.T. Conover
Comptroller of the Currency

STATEMENT OF RICH McKEE, EXECUTIVE SECRETARY, FEEDLOT DIVISION, KANSAS LIVESTOCK ASSOCIATION, ON BEHALF OF THE NATIONAL CATTLEMEN'S ASSOCIATION

Mr. Chairman, my name is Rich McKee. I am here to testify on behalf of the Kansas Livestock Association and the National

Cattlemen's Association. I am the Executive Secretary of the Feedlot Division of the Kansas Livestock Association. Our Association is pleased to join with the NCA in support of S. 2190.

Mr. Chairman, we appreciate the opportunity to express our views on the issue of mortgaged agricultural commodities. We commend you for holding this hearing, and for your interest in resolving the severe problems created by the current treatment of agricultural commodities under the Uniform Commercial Code in most states. Exempting agricultural commodities from the provisions afforded the buyers of any other good, commodity or service places an unjust burden upon the buyers of those agricultural goods.

Clear title for agricultural commodities is a priority issue for our members, many of whom buy both livestock and feedstuffs from many different sources, and have increasingly felt the burden of the present law. This is a particular problem for those who procure cattle and feed from several states as a normal business practice. Even though every reasonable precaution may be taken to assure that the commodities are free of any lien, the diversity of regulations under various state laws makes it impossible to assure that free and clear title is received.

Some have argued that removing the agricultural exemption would eliminate ". . . one of the most effective means of ensuring payments of their loans." This argument exemplifies the basis inequity of the present law: An innocent buyer, who may have reasonably attempted to protect his interest, can end up being forced to pay for the crime of another. Rather than seek repayment from the borrower who has converted sales proceeds to a use other than loan repayment, the lender simply turns to the buyer, forcing the buyer to pay twice for the commodities. No producer or feeder can ever afford this loss, and in some case this is tantamount to bankruptcy for the purchaser.

The lending community has argued that credit for agriculture will "dry up" unless agricultural commodities continue to be exempt from clear title protection for the buyer. Evidence in the one state that has extended clear title protection to buyers of agricultural commodities, California, does not support this argument. Interest rates are not higher in California, nor is agricultural credit any less available as a result of their progressive law.

Several states have recognized and taken steps to resolve this problem within their state. We commend those states that have done so. While this has eased the problem for purchasers within these states, it has not helped those who purchase agricultural commodities in several states. In fact, it may have increased the problem for many purchasers by increasing the diversity of state laws and regulations.

A substantial amount of grain as well as cattle transactions involve movement between states. Under the present system, this interstate commerce is subject to greater uncertainty. Cattle feeders, for example, may buy cattle from five or more states within a very short time period. It is impossible for them to be certain that the necessary steps are taken to protect themselves under five potentially very different state laws and regulations. The only viable and equitable solution is federal regulation which assures consistency and uniformity of the law state to state.

National Cattlemen's Association and its affiliated state associations seek changes to the law at the national level for the following reasons:

-- The "agricultural exemption" in the current law creates a barrier to free trade of agricultural commodities. This burden is not imposed upon buyers of other commodities, goods or services.

-- Anyone, whether a producer buying hay and grain, a feeder buying cattle and feed, or a packer buying cattle is in jeopardy of double payment if the seller they buy from fails to apply loan proceeds against the mortgage on the commodity. The buyer seldom has any control over how the funds are used after the transaction.

-- Regulations vary so much from state to state and even commodity to commodity within a state, that a buyer is always subject to risk of double payment, even with extreme precautions taken.

While we support and applaud the efforts to change state laws, the problem extends beyond state lines. The only reasonable solution we see is for federal legislation to remove the burden imposed solely upon the buyers of agricultural commodities.

We support Senator Huddleston's bill, S. 2190 as offered. This legislation effectively addresses the mortgaged agricultural commodities problem by eliminating the "farm products exemption" for all agricultural commodities. We commend the Senator for introducing and supporting this legislation.

Thank you for this opportunity to share our views on this very important issue.

STATEMENT OF STEVEN L. KOPPERUD, LEGISLATIVE DIRECTOR, AMERICAN FEED MANUFACTURERS ASSOCIATION

Senator Huddleston, Members of the Subcommittee, I am Steve Kopperud, Legislative Director for the American Feed Manufacturers Association (AFMA). AFMA is the National Trade Associa-

tion representing the manufacturers of over 70% of the primary formula livestock and poultry feed sold in the U.S. each year. We would like to thank Senator Huddleston for introducing S. 2190, legislation which recognizes the significant financial impact that "double payment" from undisclosed crop liens has on the good faith buyers of agricultural products.

The issue we address today is relatively simple: How to rebalance the scales so that buyers of farm products no longer bear all risk in agricultural lending. Since Article 9, Sec. 9-307(1) of the Uniform Commercial Code allows lenders to seek repayment of production loans from the first purchaser of a secured farm product, our members are constantly at risk of double payment--once to the farmer, once to the bank--if that security interest is undisclosed to the buyer and the farmer defaults on the loan.

Our industry annually buys $10-15 billion in feed ingredients, mostly grain and byproducts, making the U.S. feed industry the single largest domestic user of grain. Undisclosed crop liens represent a major uncontrolled cost factor to the feed industry. Feed represents 50-75% of the cost of producing meat, milk and eggs at the farm level. Feed ingredients on average represent about 80% of the selling price of commercial formula feeds. Anything which increases our cost of doing business over the long run must be reflected in the cost of our products to the farmer, and ultimately, in the consumer cost of meat, milk and eggs.

Our statement will do two things: it will briefly describe the current situation facing the nation's feed manufacturers under the present UCC farm products exception. It will also provide some valuable insight into the situation in California, a State which removed the farm products exception effective in 1976. The California data has been provided by the California Grain and Feed Association.

In order to get some perspective of the degree of financial burden the feed industry bears under the farm products exception, AFMA surveyed its membership and came up with some sobering statistics. Consider the following:

-- About 40% of the 170 feed companies responding to our survey indicated either a moderate or serious problem with undisclosed crop liens;

-- Of those indicating they had a problem, claims ranged from $2,500 to $50,000.

-- Risk exposure is more troublesome to quantify, but was said to be of great concern to most companies responding to our survey. Risk exposure levels were reported at a low of $50,000 for small companies, to as much as $4 million for large, multi-state firms. The average risk exposure level was around $1 million.

-- Our problem originates with both private and Government lenders with about equal frequency. A December, 1982 Farmers Home Administration survey, which included grain liens for the first time, revealed a total of $7.2 million in grain production loans referred to regional offices of General Counsel during 1982 for serious delinquency or default. This was nearly $600,000 more than livestock loans referred during the same period.

You will hear today from opponents of S. 2190 that undisclosed crop liens represent an infrequent or at best occasional problem involving a relatively small number of farmers. Our data illustrate that "a small number of farmers" is creating a potentially devastating problem for the feed industry. This "occasional" problem is considered by the Iowa Grain and Feed Association to represent the single largest out-of-pocket loss to grain buyers in the U.S.

Another argument put forward is that the problem of undisclosed crop liens exists only during a bad farm economy. Our members can attest that the problem is always with us, relected in the price we pay for grain and the cost of our products to the farmer. The problem simply goes from costly to devastating when the farm economy slumps.

You will hear that farm product purchasers can protect themselves by simply checking the proper authorities for liens when they buy farm products. The cost of checking liens on all grain purchased for feed manufacturing--in payments and manhours--is staggering, especially for firms doing business in more than one county in more than one state. First, it must be determined in which state and in which county the farmer lives; then it must be determined in which county the crop was grown so the local county seat records can be checked. Next, it must be determined who holds the lien--corporate or individual, Government or private lender--and it must be found if the lien is up-to-date and complete. One of AFMA's largest members estimates that at each of that company's grain locations, 25% of all employee time is spent researching grain liens.

Opponents of federal action warn of dire consquences if the farm products exception is lost. Perhaps this situation is best illustrated by statements made by USDA recently on deletion of the farm products exception.

USDA has said: "The commerce of farm products, including livestock, between the farm and market often involves informal, unregulated and unverifiable transactions. Such transactions are unique to farming and create unusually high risks for agricultural lenders. Section 9-307 of the UCC attempts to balance the high risk associated with agricultural lending with the inherent advantages enjoyed by the buyers of farm products."

These "unique" transactions referred to by USDA are no more unique than the sale of a tractor to the farmer. The size of the transaction, be it the sale of grain or equipment, can be quite substantial. Where the farmer purchases from a dealer or manufacturer who borrowed money against the purchased equipment, the original lender carries the risk that the dealer or manufacturer may default. The lender's recourse is in the courts--against the borrower. It is the borrower, not his customer, who broke faith and the law by not paying off the loan. The sale of grain by a producer should be governed by the same law as the sale of equipment. There is nothing "unique" about the producer's sale of grain which justifies the existing double standard.

As to the "inherent advantages" enjoyed by the buyer, what advantage is there to assuming all risk in any transaction?

USDA goes on to warn that if federal action is taken to remove the Article 9 protection, such action would "substantially increase our losses and other lenders' loss on loans, and significantly raise the cost of credit to the farmers, thus restricting the availability of agricultural credit."

This statement implies that lenders would take no action to either tighten lending practices or more closely police their loan portfolios. They would simply hike interest rates to cover the risks, or go out of the Ag lending business. This is highly unlikely given the highly profitable nature of Ag lending. To state that lending would unilaterally disappear in some areas is to say that Ag lenders would have no further interest in making a profit by lending to agriculture, or in the case of USDA, would no longer have an interest in assisting farmers obtain credit.

For the past several years, the States have individually attempted to bring some reason to this situation. However, in those efforts, the States have created a crazy quilt of Ag lending regulations that makes doing business among States even some complex than before. The State efforts have ranged from the California approach of deletion of the farm products exemption, to amending of the Code as in Illinois, to some States which have not been able to secure any relief and those which have put in place increadibly burden some mechanisms for reporting, central filing and other impractical systems.

The witness list at today's hearing includes a broad coalition of agricultural interests which have come to the same conclusion--federal pre-emption of State law is necessary to provide relief and bring consistency to laws governing agricultural product purchases. The situation in California presents the most encouraging evidence that this is possible with little or no impact on Ag lending.

California Grain and Feed Association, a State Association Member of AFMA, has asked that AFMA present its review of the California experience as part of its testimony. As CGFA Executive

Vice President Richard Matteis states: "We (California) are the state with first-hand knowledge of and practical experience with a system which insures that buyers of farm products have clear title to the commodities they buy."

Effective January 1, 1976, Sec. 9-307(1) of the California Commercial Code was amended to delete the farm products exception. This changed extended to the buyers of farm products the same protections provided to buyers of other goods. "Since that time, we know of no occasion when a buyer of farm products has had to pay twice for the same commodity. Representatives of the California Bankers Association have asserted to this fact," according to CGFA.

"Most of what you have heard from opponents of clear title legislation is pure conjecture, while we have empirical evidence that providing such protections to buyers of farm products is actually of benefit to all concerned parties--purchasers, growers and lenders," according to California grain and feed.

The situation works like this: A "buyer in the ordinary course of business" takes farm product purchases free and clear of any lien "even though the security interest is perfected and even though the buyer knows of its existence."

Under the California code, one of the definitions of "buyer in the ordinary course of business" is that the buyer be "without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party."

This has led many California lenders to routinely notify potential buyers that the security interest exists, even though the California Code does not expressly call for any type of prenotice. Checks can then be made out jointly to the lender and the farmer by the buyer. CGFA says this had led to a "simple, effective system with all parties adequately protected." Another advantage to the lenders is that they do not have to issue lien waivers so that producers may sell crops. The waivers were necessary to convince reluctant buyers to purchase possibly encumbered crops.

The California experience also negates the argument that to remove the farm products exception will place Ag lending in jeopardy. "In California, most farmers require some degree of operational financing," says CGFA. "I can tell you there are a multitude of agricultural lenders ready, willing and able to provide the required financing at rates that are affordable, despite the changes made to Sec. 9-307(1) . . . I have never heard of a single instance of a grower not being provided financing because of the clear title issue."

As to the loss of the farm products exception acting to artificially increase the cost of credit, California Grain and Feed reports that discussions with Ag lenders within California indi-

cate that the interest rate charged on a production loan is generally directly related to the perceived ability of the grower to repay the loan. This is as it should be.

You will hear that the California experience is not germane to the national discussion of clear title because somehow California is "unique." California is unique in that it is the largest agricultural producer in the country--and has remained so since removing the farm products exception. It markets more agricultural products than any other State--and has retained that distinction without the farm products exception. Says California Grain and Feeds' Matteis:

"I believe the differences between California and other States are minimal with regard to the clear title issue. The banks do have a greater responsibility than in other States . . . But it is not the burden many are claiming, and in fact has advantages for lenders as well. There is no reason our system cannot work equally well in other States."

"California has served as the pilot project on the solution to the clear title problem and the project is a success. It is now time to extend to all buyers of farm products the same protections provided to buyer of all other kinds of goods. There has not been the disruption caused in the field of agricultural financing and lenders have indicated a preference for the situation today over that which existed prior to 1976."

At question then is the lenders' willingness to accept the risks along with the profits inherent in prudent agricultural lending. Currently, buyers of farm products accept all risk in Ag lending. The lending community cannot continue to demand that buyers do the lenders' job. All lenders, including the Farmers Home Administration, have the obligation to make the best loans possible under prevailing economic circumstances. That obligation includes the servicing of those loans.

No feed manufacturer can stay in business over the long run unless he recovers all of his costs. The Article 9 farm products exception articially inflates those costs due to the risk exposure to double payment and the time and money used to search out liens. This means that over time, the livestock and poultry producer must pay more for livestock and poultry feed because the UCC farm products exception sometimes forces feed manfacturers to pay twice for the some of their major feed ingredients.

Thus, from the standpoint of grain, the current unfair situation created by the farm products exception discriminates against livestock and poultry producers by adding to their costs of production, and by extension against the consumer through higher prices for meat, milk and eggs.

AFMA strongly supports legislation like S. 2190, that will return consistency to state regulation of agricultural farm pur-

chases and end discriminatory treatment under the uniform commerical code for buyers, sellers and lenders alike.

We thank the Subcommittee for its time and consideration.

STATEMENT OF ERNEST H. VAN HOOSER, VAN HOOSER AND OLSEN, P.C. ON BEHALF OF LIVESTOCK MARKETING ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

My name is Ernest H. Van Hooser. I am a member of the law firm of Van Hooser and Olsen, P.C. of Kansas City, Missouri. The following statement is submitted by the firm in its capacity as counsel for Livestock Marketing Association, a national trade association of livestock marketing businesses.

INTRODUCTION

As a general rule, state commercial law (as embodied in the Uniform Commercial Code) fosters an open market rule which permits good faith purchasers to take goods free of perfected security interest.1/ This general rule does not, however, hold true for good faith purchasers of farm products, nor for commission merchants to act as agents in selling products. Because of the "special treatment" afforded farm products under sec. 9-307(1) of the UCC2/ (commonly referred to as the "farm products exception") and the body of law that has grown up around the farm products exception, buyers of farm products and commission merchants who assist in the transfer of farm products from seller to buyer may wind up paying twice for the same goods. This frustrates the normal expectations of buyers and commission merchants, reduces the return that farmers receive for their products, increases the cost to consumers of farm products, and generally interferes with the free and unfettered flow of agricultural products in commerce.

STATE LEGISLATION

As the problems caused by mortgaged farm products have grown,3/ buyers and commission merchants have increasingly sought corrective legislation. To date, at least sixteen states4/-not including those states that have adopted central filing for farm products5/-have enacted legislation to limit the liability of buyers or commission merchants who deal with farm products. This state legislation, however, has been far from uniform. Some of the new legislation covers all farm products. Some covers only grain. Some, such as Louisiana's and Oregon's, covers only livestock. Some, like Oklahoma's, covers everything but livestock. Some of the new legislation provides protection from liability unless actual notice of the security interest has been

NOTE: Footnotes at end of statement.

given prior to the sale or prior to payment of the sales proceeds. Some, like that in Oklahoma and North Dakota, bases protection from liability on getting a certificate of ownership from the seller and including secured parties disclosed on the certificate as joint payees. Some, like that in Nebraska and South Dakota, shortens the statute of limitations for bringing actions against buyers and commission merchants. Some of the legislation attempts to protect only commission merchants (such as livestock market agencies); some, only buyers, and some, buyers and commission merchants. Finally, some of the legislation establishes criminal penalties for borrower-sellers who either fail to provide information or provide false information with respect to potential buyers or the identity of secured parties.

STATE COURT DECISIONS

State court decisions in mortgaged farm products cases have been only slightly less disuniform than has state legislation. Some state courts have decided in favor of the buyer or commission merchant by finding that the lender somehow authorized the sale, thus relinquishing any continuing security interest in the farm products once they are sold.6/ Some courts, intent on protecting the lender's interest, have found either that the lender did not authorize the sale or that the express terms of the contract control, regardless of the parties' conduct.7/

WHY FEDERAL LEGISLATION?

There are at least two primary reasons for enacting federal legislation with respect to mortgaged farm products.

Remove Impediment to Interstate Commerce

State legislation and court decisions, because of their disparity, have created almost as many problems as they have solved. Today's markets for agricultural products tend to be national (or at least regional) rather than confined to a single state. Thus, the differences in the state law applicable to sales of farm products increases the cost of dealing with farm products and impedes the efficient flow of agricultural products in commerce.8/

Protect Against Federal Government

State legislation may not protect buyers or commission merchants from one of the nation's largest agricultural lenders, the federal Government.

It is a well-settled proposition that federal law governs questions involving the rights of the federal government arising under nationwide federal programs such as the FmHA's farm loan programs.9/ What is not so well-settled, is what is the federal

law? Is it a judicially constructed uniform rule of law, or is state law incorporated as the applicable federal law?

Prior to 1979, seven circuits had ruled on this question. Five of the seven favored a judicially constructed uniform rule of law;10/ two incorporated state law as the applicable federal law.11/

In 1979, the United States Supreme Court handed down United States v. Kimbell Foods, Inc.12/ The question before the court in Kimbell was whether contractual liens arising from certain federal loan programs take precedence over private liens, absent a federal statute that sets priorities. In reaching its decision, the court analyzed three factors: the need for uniformity in operating the federal loan programs, whether the application of state law would frustrate the specific objectives of the federal programs, and the extent to which the application of a federal rule would disrupt commercial relationships predicated on state law. Based on this analysis, the court adopted state law as the appropriate federal rule for establishing the relative priority of the competing liens.

Since Kimbell, three of the seven circuits noted previously have cited cases involving the liability of commission merchants for selling mortgaged farm products.13/ The Fourth Circuit, which already used incorporated state law as the applicable federal law, cited Kimbell as requiring the incorporation of state law. The Fifth and Ninth Circuits, which had used uniform federal law prior to Kimbell, now use incorporated state law. Thus, at this time, three circuits have decisions on the books whereby the liabiltiy of commission merchants for selling mortgaged farm products is determined under a uniform federal rule of law and four circuits have incorporated state law to determine this liability. Thus, until Congress determines the choice of law issue, either by dictating the use of a judicially constructed uniform law or incorporated state law, or by providing the specific substantive law to be followed, the only way to determine what protection, if any, all of the new state legislation will afford buyers and commission merchants against the federal government will be to litigate the issue on a case by case, circuit by circuit basis.14/ Clearly, not a very healthy environment in which to conduct business.

COMMISSION MERCHANTS

Although most of the testimony has focused on buyers of farm products, it should be noted that commission merchants, such as livestock market agencies, are just as vulnerable to liability for dealing with farm products as is a buyer of farm products.

Strictly speaking, livestock market agencies are seldom "buyers" of livestock. They do not take ownership of the livestock, but instead, act as intermediaries to move livestock from seller to buyer.15/

Since we believe that the intent of S. 2190 was to provide protection to both buyers and commission merchants, we would respectfully suggest that S. 2190 be amended to include the following additional language:

> A commission merchant or selling agent who sells farm products for others shall not be liable to the holder of a security interest in such farm products even though the security interest is perfected and even though the commission merchant or selling agent knows of its existence if the sale is made in the ordinary course of business.

CONCLUSION

In sum, Livestock Marketing Associaton believes that the problems arising from the sale of mortgaged farm products are significant and growing, especially for those who move those vitally important products from producer to consumer, and that the only real solution is for Congress to act quickly and decisively to pass corrective legislation.

FOOTNOTES

1/ U.C.C. sec. 9-307(1) provides, in part:

> A buyer in ordinary course of business... takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

2/ "A buyer in ordinary course of business...other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." (Emphasis added) sec. 9-307(1) of U.C.C.

3/ According to statistics released by the Farmers Home Administration in 1983, the FmHA, at the end of fiscal year 1978, had claims valued at $766,663.00 pending in the U.S.D.A.'s Office of General Counsel against buyers and commission merchants for converting the FmHA's interest in secured livestock. At the end of fiscal year 1982, there were claims valued at $6,581,968.00 pending. At the end of fiscal year 1978, the FmHA had no claims pending against buyers and commission merchants for converting the FmHA's interest in secured grain. At the end of fiscal 1982, there were claims valued at $7,194,321.00 pending.

4/ Nebraska, California, Georgia, Montana, Idaho, Kentucky, South Dakota, North Dakota, Tennessee, Indiana, Ohio, Louisiana, Oklahoma, Oregon, Illinois and Delaware.

5/ California (central filing, except crops), Connecticut, Delaware, Hawaii, Iowa, Maine, Mississippi (dual filing on farm products), Nevada, Oregon, South Dakota, Utah and Washington.

Although central filing somewhat eases the burden of checking for liens on a county by basis, it leaves many unsolved problems. In many cases, buyers and commission merchants cannot obtain the information on a timely basis because they are buying and selling at times when the central filing office is closed. This makes it especially difficult for livestock markets and dealers, because they are required by the Packers and Stockyards Act to pay by the close of the next business day after the transaction. Additionally, central filing, just as local filing, leaves the burden and expense of policing a lender's loan on a buyer or commission merchant rather than the lender who stands to profit by the loan. As stated by one commentator, "the risk inherent in the business of money-lending should be borne by money-lenders, not be innocent buyers in the market place." Knapp, Protecting the Buyer of Previously Encumbered Goods: Another Plea for Revision of UCC sec. 9-307(1), 15 Arizona L. Rev. 861, 892 (1973).

6/ United States v. Linsey, 455 F. Supp. 449 (N.D. Texas 1978); Hedrick Savings Bank v. Meyers, 229 N.W. 2d 252 (Iowa 1975); North Central Kansas Production Credit Assoc. v. Washington Sales Company, 577 P. 2d 35 (Kansas 1978);

Ottumwa Productin Credit Assoc. v. Heinold Hog Market, Inc., 340 N.W. 2d 801 (Iowa App. 1983);

Charter Bank of Butler v. Central Cooperatives, Inc., ___ S.W. ___, No. 34,442, Mo. App., March 13, 1984.

7/ United States v. Chesley's Sales, Inc., 523 F. Supp. 528 (W.D. PA 1981); United States v. Riceland Foods, Inc., 504 F. Supp. 1258 (E.D. AR 1981); United States v. Smith, 22 UCC Rep. 502 (N.D. Miss. 1977); Oxford Production Credit Assoc. v. Dye, 368 So. 2d 241 (Miss. 1979); Garden City Production Credit Assoc. v. Lannan, 186 Neb. 668, 186 N.W. 2d 99 (1971); Southwest Washington Productin Credit Assoc. v. Seattle First National Bank, 92 Wash. 2d 30, 593 P.2d 167 (1979).

8/ Congress, by the Packers and Stockyards Act, 1921 has made dealing with "livestock, meats, meat food products, livestock products..."transactions in interstate commerce. 7 U.S.C. d 181, sec. 183

9/ United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979); Clearfield Trust Company v. United States, 318 U.S. 363 (1943); D'Oench, Duhme and Company v. Federal Deposit Insurance Corp., 315 U.S. 447 (1942)

10/ Third Circuit: United States v. Summerville, 324 F.2d 712 (3rd Cir. 1964); Fifth Circuit: United States v. Hext, 444 F.2d

804 (5th Cir. 1971); Sixth Circuit: United States v. Burnette-Carter Company, 575 F.2d 587 (6th Cir. 1978) and United States v. Carson, 372 F. 2d 429 (6th Cir. 1967); Ninth Circuit: United States v. Matthews, 244 F.2d 626 (9th Cir. 1957); Tenth Circuit: Cassidy Commission Company v. United States, 387 F. 2d 875 (10th Cir. 1967).

11/ Fourth Circuit: United States v. Union Livestock Sales Company, 298 F.2d 755 (4th Cir. 1962);

Eighth Circuit: United States v. Gallatin Livestock Auction, Inc., 448 F. Supp. 616 (W.D. MO 1978), affirmed, 589 F.2d 353 (8th Cir. 1978).

12/ United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979).

13/ Fourth Circuit: United States v. Friend's Stockyard, Inc., 600 F.2d 9 (4th Cir. 1979);

Fifth Circuit: United States v. Southeast Mississippi Farmers Livestock Assoc., 619 F.2d 435 (5th Cir. 1980);

Ninth Circuit: United States v. Public Auction Yards, 637 F.2d 613 (9th Cir. 1980). 14/ Lest anyone believe that the federal government has accepted the proposition that Kimbell requires the incorporation of state law as the applicable federal law in mortgaged livestock cases, the author is personally familiar with a number of lawsuits where this issue is still being litigated.

15/ See, Greater Louisville Auction Co., Inc. v. Ogle Buick, Inc., 387 S.W. 2d 17 (Ky. 1965); Commercial Credit Corp. v. Joplin Auto Auction Co., 430 S.W.2d 440 (MO 1978).

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October 2, 1984

Senator Walter D. Huddleston
S.D.-262
Dirksen Senate Office Building
Washington, D.C. 20515

Dear Senator Huddleston:

Because of the time constraints at the hearing on S. 2190 last week, a number of statements made by the lenders did not receive ample response. I, therefore, have taken the liberty of addressing four of those statements below.

First, one of the lenders stated that a buyer could easily avoid "double jeopardy" merely by running a simple lien check on the seller. Such is not the case. First of all, running a lien check is not simple. Because the instrument that is filed to give notice of a lien is a financing statement, rather than an actual copy of the security agreement itself, a buyer cannot merely check with a filing office to determine if a lender has a lien on the farm products being sold. In order to protect himself, a buyer must also check with the secured party listed on the financing statement to determine (1) what specific farm products collateral is covered by the security agreement and (2) whether the security agreement is still in effect. A lien check, therefore, cannot be done in one easy step. It is a two step process, which must be followed for each seller, at each sale, for each secured party who has a financing statement on file.

Additionally, because farm products are routinely sold across state lines, a buyer must be familiar with not only his own state's manner of handling lien checks, but also the manner in which every state from which be buys farm products handles lien checks. For example, many filing offices will not provide lien information in response to a telephone inquiry: they require a written request with payment in advance. In areas where this practice is followed it becomes practically impossible for livestock buyers and livestock auction markets to run a lien check and still comply with the prompt payment provisions of the Packers and Stockyards Act. Thus, livestock buyers and auction markets are faced with a dilemma: take the time necessary to check liens and face penalties for violating the Packers and Stockyards Act, or comply with the Packers and Stockyards Act and face claims for dealing with mortgaged farm products.

Even if running a lien check were simple, it's often worthless. The farm products exception of sec. 9-307 has been justified on the ground that buyers of farm products are sophisticated enough to know that their seller may have mortgaged the farm products he is selling. The problem with this justification is that a buyer, no matter what his level of sophistication regarding agricultural financing, may not be able to determine whether the goods he has purchasing are mortgaged or not. If, for example, a person is purchasing livestock from a livestock dealer, that person would expect, as a buyer of inventory, to take free of any security interest in the livestock. He would not know the identity of all of the farmers who had sold livestock to the dealer so that he could run lien checks on all of them. Yet, if the dealer had purchased the livestock from a farmer who had granted his bank a security interest in the livestock, the purchaser from the dealer would take subject to the security interest created by the farmer because the buyer only takes free of security interest created by his seller (the dealer), not prior sellers.

Second, another justification for the farm products exception that the lenders cited is that sales of farm products are more closely akin to bulk sales than to sales of inventory. Thus,

goes the argument, because farm products are not subject to the creditor protections afforded by Article 6 of the Uniform Commercial Code lenders must have the protection afforded by the farm products exception in order to protect their interest. This justification, although somewhat persuasive at first glance, encounters problems when examined closely, especially with respect to livestock. For example, a dairy herd is a constantly changing asset. Poor producers are culled and replaced. Male increase, being outside the normal scope of a dairy farmer's business, are sold. It is difficult to see how this continuing turnover of small number of animals is akin to a bulk sale. Even grain, because of the more sophisticated marketing techniques now being used by farmers, will often not be sold at one time; it will instead be sold over a period of months to take advantage of "off season prices" and to fulfill forward contracts.

Third, another statement made by the lenders at the hearing last week was that state legislative solutions are superior to any federal legislative solution because the individual states have, and will, enact legislation deal with problems that are unique to each individual state. Having been involved with attempts to pass farm products legislation in a number of states, I can assure you that the resulting legislation does not differ from state to state because of unique state problems. The state legislation differs from state to state because of the prevailing political environment in each individual state.

Finally, a number of lenders at the hearing stated that if S. 2190 were enacted, it would effectively cut off the lender's security in farm products collateral. This simply is not so. In order to be a buyer in ordinary course of business a person would have to take the farm products in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party. Thus, under S. 2190, lenders could still protect themselves by giving potential buyers actual notice of the security interest and advising potential buyers that unauthorized sale of the collateral would be a violation of the lender's security interest.

In sum, the justifications cited by the lenders at the hearing last week for leaving the farm products exception intact rest on questionable grounds. When buyers cannot protect themselves without an inordinate expenditure of time and money, the result is economic loss for the entire agricultural community and all those associated with it.

If I can do anything to assist you with S. 2190 or if you have any questions whatsoever about the points discussed in this letter, please do not hesitate to call me. I shall be happy to help in any way I can.

Thank you for your continuing interest in this vitally important subject.

Sincerely,

Ernest H. Van Hooser

STATEMENT OF NEAL P. GILLEN, VICE PRESIDENT AND GENERAL COUNSEL AMERICAN COTTON SHIPPERS ASSOCIATION

Mr. Chairman, I am Neal P. Gillen, Vice President and General Counsel of the American Cotton Shippers Association. Our member firms conducting business in the 16 cotton belt states purchase and sell 80% of the cotton sold to U.S. mills and 90% of the cotton sold in the export market.

I appear today to express the support of the association for S. 2190 which amends Section 9-307(1) of the Uniform Commecial Code allowing purchasers of farm products in the ordinary course of business to purchase such goods free of any perfected security interest.

Section 9-307(1) provides that "a buyer in ordinary course of business1/ other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."

Through Section 9-307(1) agricultural lenders are placed in a more secure position than commercial lenders, and the purchasers of agricultural products are subject to a burden not placed upon the purchasers of industrial products or consumer goods, given that the buyers of agricultural products are placed in the role of guarantors in the event that the producer does not repay his or her loan with the proceeds from the sale of crops or livestock.

Prior to the adoption of the Uniform Commercial Code in the 1960's, it's predecessor the Uniform Conditional Sales Act placed all purchasers of goods in the role of guarantor. This standard was deemed too harsh by those who drafted the U.C.C. and all purchasers of goods, except those purchasing from farmers were provided the right to take free of a security interest while buying goods in the ordinary course of business.

U.C.C. Hinders Agricultural Marketing

The complexities of the Uniform Commercial Code place too onerous a burden on the initial purchaser of agricultural commodities, thus hindering the trade in such goods. Unlike the

NOTE: Footnotes at end of statement.

purchasers of other goods, an agricultural purchaser is required to conduct a lien search, similar to a title search on real estate, in each county clerk's office in the counties that the producer owns or leases land on which crops or livestock are raised. Crop liens are recorded with the liens on cars, campers, furniture, appliances, and other personal property, are not necessarily listed in alphabetical order, not always in the best handwriting, do not list the amount of the crop lien, and do not specifically identify the type of crop or livestock subject to the lien. If one undertakes the time and expense to conduct a lien search, and does in fact uncover a lien, it is necessary to contact the lending agency to determine what crop (cotton, wheat, corn, soybeans, etc...) or what type of livestock (cattle, hogs, sheep, etc...) is subject to a lien. If the crop or livestock purchased is under lien or liens, the buyer may be obliged to make payment jointly or severally to the farmer and the lending agencies. Liens generally cannot be searched through a telephone call, and if the search is conducted by a county employee a service charge not less than $5 per search is usually charged.

The initial purchaser of farm products be it a cattle barn, country elevator, or country cotton buyer is ill equipped to undertake a search of lien ledgers in county court houses, and cannot afford the additional overhead necessitated by lien searches. When crops move at harvest the elevator operator finds farm trucks lined up with grain to be weighed, sampled, off-loaded, and warehouse receipts to be issued and little or no time to call or visit the county clerk's office to inquire about crop liens. The Packers and Stockyards Act requires the cattle barn operator to make payment for livestock prior to the close of business the following day, making the lien search almost a moot question. The country cotton buyer usually purchases all or a substantial part of the cotton processed at a particular gin with payment made to the gin. Here, the buyer has no idea of the identity of the farmers and potential liability hinges upon whether the ginner acted as the agent of the buyer or the farmer. Another factor is the delays inherent in a proper lien search which could prove costly to the seller or the buyer in times of fluctuating prices.

The Recent Experience of the Cotton Industry

The economic downturn, combined with the overall deterioration in farm prices, the accumulation of large stocks, the resulting increase in farm debt, and the number of defaults on farm loans caused credit institutions to assert all of their rights under the Uniform Commercial Code, including attempts to satisfy liens from buyers, who unknowingly purchased cotton, subject to a lien, from farmers who subsequently defaulted on the loans made to them by the lienholder.

At the outset of the 1982 marketing season it was apparent that a substantial portion of the cotton crop was encumbered by liens. I advised our members to presume that a lien existed, cautioned

them to determine whether in fact a lien existed, and if so, to make payment jointly and or severally to the producer and the lien holder(s).

This advisory procedure proved difficult if not impossible to implement by those buying cotton in the country, and they were quick to inform me that such was the case. I visited a number of cotton firms in the Midsouth and Southwest to investigate the problem, and to discuss what could be done to limit or ease the burden of determining the existence of a lien and the indentity of the lien holder(s). The personal inspection of lien ledgers by me, other attorneys and cotton buyers in county courthouses throughout the cotton belt revealed an inconsistent and sometimes incomprehensible system of recording liens.

At the county clerk's office in Lubbock, Texas, I discovered the names of two farmers with FmHA liens recorded on their 1981 and 1982 crops, but when I checked the list of crop liens at the FmHA office, in the Federal Building across the street, the names were not listed, and the clerk had no explanation for the discrepancy. The converse was also evident, in that the name of a producer listed on the FmHA list could not be found in the county clerk's office.

Mr. Chairman why must a buyer of farm products in the ordinary course of business be subject to such a burden, such confusion?

Given the difficulty of conducting lien searches I concluded that the risk of liability might be reduced if FmHA, the PCAs and the Banks would provide my office with a list of the producers on which they held crop liens. Starting in September 1982, the association staff checked with a number of banks in different cotton producing states, and without exception were told the bank could not divulge such information, but you could check the county clerk's office to see if a lien was recorded.

Thinking that the establishment a central depository of crop liens might ease the difficulties encountered by our member firms, I sought out the cooperation of the Farmers Home Administration and the Farm Credit Administration. I was informed that neither of these organizations, had such information. It would be necessary to write the individual State FmHA offices and request a list of the cotton counties, then individually write each county requesting a list. To determine the PCA liens it would be necessary to contact the Intermediate Credit Banks and request the names and addresses of the Production Credit Associations in the various States. This exacting task required that the writing of 301 letters to the FmHA State and County offices. There are 287 cotton counties in the U.S., excluding Texas,* and it took 8 months before all counties responded.

Production Credit Associations were not as cooperative as the FmHA offices. 221 letters were written to the Intermediate Credit Banks and the 213 Production Credit Association offices

located in the cotton producing states. Approximately half of these offices responded, usually informing us they could not make this information available for policy reasons. It was only in the Southeast that the PCA's provided lists of producers with PCA liens on their crops. The Federal Intermediate Credit Banks have adopted a policy of not providing such information, requiring our members to contact the PCAs located in the areas in which they operate for lien information.

It is interesting to note that those FmHA and PCA offices providing a list of liens, disclaimed the accuracy of the list and advised us to search the liens recorded in the county clerk's office in the county where the crop was produced.

Sec. 9-307(1) Places Onerous Legal Burden Upon Buyer

Section 9-207(1) places too onerous a burden on agricultural buyers, and the burden of risk should be placed where it properly belongs, in the hands of the parties to the loan, the lendor and the borrower.

Aside from the difficulty of searching records to determine if a lien exists, consider the complexity faced when interpreting the UCC as an integrated document. Under Section 9-307(1), if a lien is perfected (recorded), the lien holder has the right against the initial purchaser, and possibly against a subsequent purchaser under Section 9-306(2), or whenever an agency relationship exists. However, under Section 9-301, if a lien is not perfected before the crop is sold and delivered to a buyer, who in the ordinary course of business has no notice of the existence of a lien, the lien holder has no rights against the purchaser--his sole recourse is to collect from the farmer.

Another exception concerns itself with so called documents of title and raises the question of whether a third party buyer can defend against a security interest. Cotton warehouse receipts are considered documents of title and Section 7-503(1) states that a document of title confers "no right in goods against a person who before issuance of the document had a legal interest or a perfected security interest in them." There are two exceptions to this rule and they directly bear on the trading of cotton. If it can be shown that the person who claims the interest in the goods (lien holder) took either of the following two actions, the buyer is protected from the lien holder's claim against him:

1. If the lien holder(s) "delivered or entrusted them or any document of title covering them to the bailor or his nominee with actual or apparent authority to ship, store or sell or with power to obtain delivery under" the UCC.

2. If the lien holder(s) "acquiesced in the procurement by the bailor or his nominee of any document of title."

Another consideration is the 1971 decision of the Fifth Circuit U.S. Court of Appeals in the case of U.S. v. Hext & Harlingen Compress Co. & Marshall & Marshall (44 Fed 804). The court found that the U.C.C. shall apply to suits involving FmHA liens and that Sections 9-307(1) and 1-201(9) were critical. The case was decided however on the same principles of Section 7-503(1).

The court ruled "that the Gin Co. was in the business of selling cotton," that Marshall & Marshall "were buyers in the ordinary course of business," and that "ginned cotton is in the category of farm products" under 9-307(1). "However," the court said "in order for the FmHA's security interest to continue in the cotton by virtue of the exception from Section 9-307(1) pertaining to buyers of farm products, the farm products must be bought 'from a person engaged in farming operations'."

Despite the fact that Hext the ginner was also the farmer on who's crop FmHA held the lien, the court held "that the buyers ...bought from the Gin Co., and not from Hext himself. They did not therefore purchase from a person engaged in farming operations within the meaning of section 9-307(1)."

The court in determining no liability on the part of Marshall and Harlingen Compress did state however, that "the fact that mortgaged cotton is sold by a farmer-debtor to a gin and then by the gin in the ordinary course of business to a buyer, does not, in the normal transaction, extinguish the security interest." Marshall and Harlingen Compress took free of the security interest, the court opined, because "the FmHA took a security interest in goods ...as farm products, knowing that the debtor had the capability of transferring them into the category of inventory and selling them in the ordinary course of his gin business. The buyers of the cotton thus took free of the security interest and could not themselves be sued by the government for conversion."

In a footnote the court stated that "the same result would obtain under article 7(7-503(1) of the code if the transactions here be viewed as involving the purchase of negotiable documents of title (warehouse receipts) rather than the purchase of the cotton itself."

One can infer that the court, in finding that the farmer-ginner was acting as a ginner when he made the sale, considered Section 9-307(1) too onerous a burden on the buyer.

A more recent case decided July 9, 1982, by the Fifth Circuit, U.S. v. Weems & Brown Ellington Cotton Company & Downes Cotton Company & Warsaw Elevator, is instructive.

In 1977 the farmer (Weems) had pledged his cotton and soybean crop to FmHA. The crops were sold without notice to or the consent of FmHA. The farmer identified himself as Jack Weems giving his address as Delhi or Baskin, Louisiana and represented the

crop was unencumbered by a lien. The buyers checked the FmHA list of crop liens which listed Charles R. Weems, neglecting to check if Charles R. and Jack were the same individual.

The court discussed the fact that the due care of the buyer, not his good faith is the appropriate standard. The real issue was the validity of the crop lien, and that when the lien is properly recorded, it is effective against third persons, so that the immediate purchaser of a crop subject to the lien buys with constructive notice of the pledge, and is personally liable to the crop pledgee, or at least up to the value of the crop purchased by him.

In a case pending in Alabama, a member firm purchased 1980 cotton subject to a crop lien and FmHA is requesting payment. The buyer asked the farmer if the crop was subject to a "bank lien." The farmer answered the question affirmatively and the merchant made payment to the farmer and the bank. The farmer failed to mention the existence of an FmHA lien, and FmHA is seeking indemnity from the merchant, the farmer being insolvent.

The Alabama case is a prime example of the inequities inherent in the Code, and illustrative of the fact that in the trade of cotton the legal burdens are cast upon those individuals least equipped to deal with them, the country buyers and ginners. The farmer prefers to deal with a local buyer, someone he knows and can trust. The buyer in turn must trust his customer. The UCC, however, holds him liable if the farmer defaults on his loan, a loan to which he was not a party, but a loan on which he may be a guarantor. This onerous burden hinders the efficient marketing of cotton and should be deleted from the UCC.

Burden of Risk Rests on Wrong Party—
Lendor and Creditor Must Bear the Entire Burden of Risk

Should farm lending agencies be placed in a position superior to that of the purchaser of the farmer's production?

Should the purchaser be required to police the lending agency's loan?

Should the purchaser be required to pay the creditor, when the creditor has failed to properly supervise its' accounts?

Should purchasers of nonagricultural products enjoy special treatment under the Uniform Commercial Code?

Each question merits a negative response in 1983, given the changes that have occured in agricultural production, marketing, and banking since the U.C.C. was drafted in the 1950's.

The need to amend Section 9-307(1) is compelling and long overdue.2/ Over the course of the past year efforts have been underway in a number of States to enact legislation similar to

that passed by California in 1974.3/ Our association has been active in a number of cotton producing States, and I have personally appeared and testified in Oklahoma and Texas.

Members of the various legislatures uniformly share our concern, understand the problem, but have no uniform solution. Our successful experience in Oklahoma4/ and Tennessee5/ evinces that for each legislature there is a different solution. The need for uniformity is essential, and we believe that it can only be achieved through an Act of Congress. Given that Congress and the U.S. Supreme Court deem agricultural products to directly burden or affect interstate commerce, the Congress has authority to preempt the individual States by enacting laws dealing with the sale of agricultural products, and since Section 9-307(1) clearly places a burden on the interstate sale of agricultural products the need for Congress to act is compelling.

Thank you for this opportunity to relate our experience with section 9-307(1) and to express our views on the need to amend 9-307(1) through an Act of Congress.

Footnotes

1/ Sec. 1-201(9) "'Buyer in ordinary course of business' means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind..."

* The Texas Cotton Association maintains the FmHA list of liens for the Texas FmHA County Offices.

2/ The special classification given to farm products by Section 9-307(1) is the subject of comment by Sorelle in "Farm Products Under the Uniform Commercial: Is a Special Classification Desirable?" 47 Texas L. Rev. 309-15 (1969). Attachment A

3/ California Stats. 1974, c. 997, P. 2129, Sec. 26, effective Jan. 1, 1976. Sec. 9307 Commercial Code (1) ammended to read "A buyer in ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."

4/ Attachment B

5/ Attachment C

ATTACHMENT A
"FARM PRODUCTS" UNDER THE UCC—IS A SPECIAL CLASSIFICATION DESIRABLE?

A. W. SORELLE III

I. Introduction

Article 9 of the Uniform Commercial Code[1] regulates secured transactions in most personal property, including crops and livestock produced by farm operators.[2] By permitting direct methods for acquiring a security interest in future crops and other after-acquired property,[3] the Code has increased the value of the farmer's collateral and provided better security for lenders.[4] The procedures for perfecting a security interest in goods have been simplified and lenders have been aided by the Code's rejection of all the previously imposed policing requirements.[5]

These improvements are largely codifications of pre-Code practices that were accomplished through various indirect methods.[6] To the extent the changes affected farm financial transactions, both the farmer and the lender were placed in more favorable positions. The Code does, however, single out the farmer for special treatment that can adversely affect third parties to farm financing transactions. This Comment will be limited to a discussion of that special treatment and the desirability of retaining the "farm products" classification of goods.[7]

II. Farmers Are Not Merchants

The term "goods" is used in the Code to denote all property that is movable at the time a security interest will attach.[8] Goods are then

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1 The Uniform Commercial Code will be cited throughout by section number only, and reference is made to the 1962 Official Text and Comment Edition of the Uniform Commercial Code.

2 With certain exceptions, "this Article applies so far as concerns any personal property and fixtures within the jurisdiction of this state." § 9-102(1). Exceptions are found in §§ 9-103,-104.

3 Section 9-204(3).

4 Prior to the Code, the common law and most mortgaging statutes held that no valid mortgage could be drawn to cover property not then existing. *E.g.*, Williams v. King, 206 S.W. 106, 107 (Tex. Civ. App.—Austin 1918, no writ). This lessened the value for mortgaging purposes of future crops and other future acquisitions of the farmer. Equity would sometimes enforce a mortgage on future crops, however, if it was clear that the parties contemplated a binding mortgage on the crops. *E.g.*, Perkins v. Alexander, 209 S.W. 789, 790 (Tex. Civ. App.—Dallas 1919, no writ). *See* Coates, *Farm Secured Transactions Under the UCC*, 23 Bus. Law. 195, 196-97 (1967).

5 "A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle or dispose of all or part of the collateral." § 9-205.

6 *See* G. Coates, Law and Practice in Chattel Secured Farm Credit 12-17 (1954).

7 For a general treatment of secured transactions in farm goods *see* 2 G. Gilmore, Security Interests in Personal Property 677-715 (1965); Coates, *supra* note 4; Coogan & Mays, *Crop Financing and Article 9: A Dialogue With Particular Emphasis on the Problems of Florida Citrus Crop Financing*, 22 Miami L. Rev. 13 (1967).

8 Section 9-105(1)(f).

further classified as "consumer goods,"[9] "equipment,"[10] "farm products,"[11] and "inventory."[12] All the subclassifications, except farm products, are based on the purpose for which the goods are held. Farm products, however, are defined as "crops or livestock or supplies used or produced in farming operations . . . if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations."[13] Thus the farm products classification is based on the occupation of the holder rather than the purpose for which the goods are held.[14]

Without the special treatment given farm products, crops and livestock held for sale by a farmer would fall into the inventory classification, which includes all goods held for sale.[15] Since the same cattle or grain the farmer holds as farm products are held by a packer or broker as inventory, it becomes clear that those drafting the Code considered farmers, as an occupational group, to be somehow different from all other business operators.

The most noticeable effect of this special treatment is that the position of a purchaser of farm products differs from that of a buyer of inventory. Section 9-307(1) states that a buyer of goods in the "ordinary course of business"[16] takes free of a security interest created by his seller. The same section provides, however, that the buyer must be someone "other than a person buying farm products from a person engaged in farming operations."[17] Thus a person purchasing farm products takes subject to a perfected security interest although he had no actual knowledge of the security interest.[18] The buyer can

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9 Goods that "are used or bought for use primarily for personal, family or household purposes." § 9-109(1).

10 Goods that "are used or bought for use primarily in business . . . or if the goods are not included in the definitions of inventory, farm products or consumer goods." § 9-109(2).

11 Section 9-109(3).

12 Goods that are "held by a person who holds them for sale or lease or to be furnished under contracts of service . . . or if they are raw materials, work in progress or materials used or consumed in a business." § 9-109(4).

13 Section 9-109(3).

14 *See* Ruud, *Article 9 of the Uniform Commercial Code—Its Structure and Applicability*, 44 TEXAS L. REV. 685, 689 (1966).

15 There may be exceptions such as a liquidating type sale that would fall into the classification of a "bulk transfer" and be excluded from the operation of article 9. *See* § 6-102; Ruud, *supra* note 14, at 689.

16 A buyer in the ordinary course of business is

> a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in the ordinary course from a person in the business of selling goods of that kind.

§ 1-201(9).

17 Section 9-307(1).

18 Unless an exception is provided by another section of the Code, a security agreement is effective "against purchasers of the collateral and against creditors." § 9-201.

protect himself only by undertaking an onerous search of financing statements.[19]

Various reasons may be advanced for placing the farmer's goods in a separate category. One explanation that has been offered is that a farmer is not considered competent to market his own products. Although dealing with another part of the Code, an Arkansas court in *Cook Grains, Incorporated v. Fallis*[20] held that a farmer could not be considered a "merchant"[21] because this term indicates a certain level of skill and knowledge in dealing with his goods.[22] It has been suggested that those drafting the Code also had a rather antiquated view of the farmer and considered him to lack the business judgment to handle his own financial transactions.[23] A quick examination of modern farm operations, however, should dispel this impression. Today's farmer manages a business with a large capital investment in property and equipment and a large cash flow.[24] As the number of farmers has been decreasing, the size and value of farms have been increasing.[25] Consequently, the farmer today is better educated and more aware of the business practices in his profession.

The usual reason given for the farm products exception to section 9-307, however, is that added security is necessary to encourage lenders to advance money on farm collateral.[26] Undoubtedly, allowing a purchaser of farm products to take free of a security interest would increase the risk of a creditor. It is doubtful, however, that loans to farmers on this type collateral would be greatly affected. Crops and livestock are readily marketable goods whose value is easily ascertained; farmers are no less honest than persons in other business occupations;[27] and, under the Code the secured party could obtain a perfected security

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19 To perfect a security interest in farm products, a financing statement must be filed in the county clerk's office of the debtor's home county and, when crops are involved, in the county where the land is located. § 9-401; *see* Ruud, *The Perfection of Security Interests Under Article 9 of the Uniform Commercial Code—How? When? Where? How Often?*, 44 TEXAS L. REV. 724 (1966).

20 239 Ark. 962, 395 S.W.2d 555 (1965).

21 "[A] person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction . . . " § 2-104(1).

22 There is nothing whatever in the statute [the UCC] indicating that the word "merchant" should apply to a farmer when he is acting in the capacity of a farmer, and he comes within that category when he is merely trying to sell the the commodities he has raised.
239 Ark. at 965, 395 S.W.2d at 557.

23 Coogan & Mays, *supra* note 7, at 19.

24 The average value of a farm in 1964 was $51,000. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 608 (88th ed. 1967). Rep. Jamie L. Whitten, Chairman, House Appropriations Subcommittee on Farm Program Funds, recently stated: "Today, a man has to make an average investment of $73,120 to start a farm and $37,600 additional for each worker." FAMILY WEEKLY, Oct. 13, 1968, at 2.

25 FAMILY WEEKLY, Oct. 13, 1968, at 2.

26 *See* 8 NATURAL RES. J. 183, 189 (1968), 20 BAYLOR L. REV. 136, 137 (1967).

27 *See generally* G. COATES, *supra* note 6, at 41-43.

interest in the proceeds of a sale and would not be left without a remedy. Thus the controlling issue becomes whether to place the risk of the dishonest debtor on the buyer or on the secured party.

III. The Secured Party Versus the Buyer

Under pre-Code law a properly executed chattel mortgage on crops and livestock protected the lender in much the same way a security interest protects him under the Code.[28] When the creditor gave the debtor free use of the collateral and failed to police the lending agreement, however, the courts would sometimes invalidate the mortgage or its terms to protect a buyer or other creditor.[29] The rule of *Benedict v. Ratner*,[30] or the policing rule,[31] was based on the idea that buyers and other creditors should be able to rely on a debtor's unfettered possession as an indication that he had authority to dispose of the collateral. The Code, however, specifically rejects the policing concept and relies on filing requirements to provide protection for third parties. While this approach improves the position of the creditor, it frustrates buyers of farm products who would prefer to rely on possession as an indication of authority to sell.

In practice, buyers will probably continue to rely on the debtor's possession and past performance as proof that the debtor has authority to market his crops or livestock. Large-scale crop buyers will find it inconvenient and costly to examine records in the home county of every farmer who delivers crops for sale. An individual purchasing cattle in small lots through an auction house will also find the burden of a record search far too onerous to undertake. Furthermore, the auctioneer likely will not be able to conduct the search because of the sheer volume of transactions. The secured party will normally be quite satisfied for the farmer to make his own sales decisions and simply return the proceeds of the sale.[32] The debtor will usually remit the proceeds to the secured party, and no problem will arise even if the debtor did not have authority to make the sale. Even under pre-Code law when creditors ran greater risks for failure to enforce the terms of their agreements, most creditors relied on the general honesty of the debtor and allowed the debtor to use the collateral as he saw fit.

Since farmers are treated in practice like other merchants or

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28 *Id.* at 32-41.

29 *E.g.*, Coleman Production Credit Ass'n v. Mahan, 168 S.W.2d 903, 904 (Tex. Civ. App.—Eastland 1943, no writ).

30 268 U.S. 353 (1925).

31 So named because the creditor could lose his rights against other creditors and buyers if he did not enforce or *police* his agreement. Policing usually included insuring that the debtor did not commingle the goods with others not covered and did not conduct sales and purchases of the collateral without authority. § 9-205, Comment 1.

32 G. Coates, *supra* note 6, at 46.

producers of goods for sale, it appears that purchasers of farm products should also be treated like buyers of other goods.[33] The protection of farm purchasers would also have the beneficial effect of improving the general marketing of goods. Transactions would be completed more rapidly because buyers would no longer be forced either to undertake an onerous record search or to depend solely on the honesty of the vendor.

Since almost all crop and livestock operations contemplate the sale of goods, there appears to be no reason to distinguish such sales from other types of selling transactions. If commercial law is to reflect commercial practice, buyers of farm products should be protected.

IV. Judicial Approach to the Problem

Since practice does not conform to Code procedure in farm financing transactions, courts are likely to become involved in disputes between holders of security interests in farm products and third parties. One of the first cases to arise in this area caused a New Mexico court to strain the law of waiver to protect a cattle auctioneer who had relied on past practices and sold cattle for a debtor in violation of the debtor's security agreement. *Clovis National Bank v. Thomas*[34] involved a security agreement covering cattle in which the secured party required the debtor to obtain written consent before disposing of the secured goods. Defendant, a commission agent, sold the cattle and remitted the proceeds to the debtor, who failed to apply them against his debt. The secured party sued the defendant for conversion, relying on his perfected security interest. The court found that the secured party had waived his right to demand written consent by failing to object to similar sales in the past and that this conduct had given implied consent to sell.[35]

The decision has been heavily criticized.[36] Since there was no evidence that the secured party had any intent to waive his right to written consent, an important element of waiver was missing.[37] Furthermore, the Code specifically provides that express provisions of a contractual agreement will take precedence over course of trade.[38] Also, the Code's rejection of policing requirements would seem to make the

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[33] *See* 65 Mich. L. Rev. 345, 350-51 (1966).

[34] 77 N.M. 554, 425 P.2d 726 (1967).

[35] *Id.* at 563, 425 P.2d at 730.

[36] *Id.* at 569, 425 P.2d at 734 (dissenting opinion); 8 Natural Res. J. 183 (1968); 20 Baylor L. Rev. 136 (1967).

[37] *See* Bering Mfg. Co. v. W.T. Carter & Bros., 255 S.W. 243 (Tex. Civ. App.—Beaumont 1923), *aff'd*, 272 S.W. 1105 (Tex. Comm'n App. 1925, jdgmt adopted).

[38] Section 1-205(4). In response to *Clovis*, the New Mexico Legislature amended § 1-205(4) of their version of the Code to provide: "A security interest in farm products shall not be considered waived by the secured party by any course of dealing between the parties or by any trade usage." N.M. Stat. Ann. § 50A-1-205(4) (Interim Supp. 1968).

secured party's conduct less meaningful. Even if the elements of waiver were present, it is not clear that an auction house would be protected since it acts as the agent of the debtor and could stand in no better position than its principal.

Clovis indicates the type of problems which will be presented to courts in other states. Many security agreements will require the debtor to obtain permission to dispose of collateral, but will not require that this authority be in writing, or otherwise expressed. In this situation, it is easily foreseeable that courts will be able to find some implied authority for sale in the past conduct of a secured party in his relation to the debtor. When a good-faith purchaser who has relied on the past performance of the debtor under similar financing arrangements is involved, courts are likely to go to extreme lengths to protect him. If the court is able to find some authority for the sale, the buyer would then take free of the security interest.[39]

The section 9-307 treatment of farm products raises another unusual question of priority between the buyer and the secured party. When farm products pass into the hands of a nonfarmer, they lose their farm products classification and become inventory. Although section 9-307 protects a subsequent purchaser from a security interest created by a holder of inventory, it does not destroy a security interest that attached when the goods were farm products.[40] Thus there has been conjecture that a security interest in crops or livestock might follow the goods to the kitchen table.[41] Although courts would clearly not allow such an extreme extension, many parties less remote in the chain of possession to the farmer could be adversely affected. The packer who buys cattle from a broker could still be subject to the security interest created by the farmer who sold to the broker, even though the cattle were classified as inventory in the broker's hands.

Although courts will probably protect innocent parties from the harsh operation of section 9-307, judicial resolution of the problem creates the double danger of a lack of uniformity in Code interpretation and the stretching of legal theories beyond their reasonable scope. Therefore, a legislative solution seems preferable.

V. Legislative Solutions

The most obvious approach to the problem would be the removal of the farm products exception from section 9-307. A buyer of farm

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39 If the secured party authorizes disposition in the security agreement "or otherwise," the security interest will not continue in the collateral. § 9-306(2).

40 Section 9-307(1) affects only security interests created by the seller. Since the nonfarmer did not create the security interest, the buyer will not be protected by this section.

41 1 P. Coogan, W. Hogan & D. Vagts, Secured Transactions Under the Uniform Code 476 (1967).

goods would then take free of security interests created by the farmer. After removal, however, the farm products classification would become unnecessary, since only one other section uses the term "farm products" and a nontechnical use of the term in that section would cause no confusion or change in application.[42] Thus it appears that a better solution would be to delete completely an otherwise useless classification of goods. Crops, livestock, or supplies held for sale by a farmer would then fall into the classification of inventory. Complete deletion would also aid in the removal of an unwarranted distinction between farming and other business occupations.

The legislative solution suggested above would make the law conform with commercial practice while retaining uniformity in the Code's application. The secured party's position would be unaffected by the change except in a situation where the debtor violates the security agreement and sells to a good-faith purchaser. The secured creditor still would have freedom to make varying contractual arrangements with the debtor, and his priority among other creditors would be unaffected. When the debtor sells in violation of a security agreement, however, the buyer would be protected. This result places the risk of the dishonest debtor on the secured party, who is better able to protect himself by judicious lending policies.

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42 The term "farm products" is used in § 9-401, which concerns filing requirements, but would not be misunderstood in a nontechnical sense. § 9-401.

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ATTACHMENT B

Chapter 114, Public Laws 1983

Senate Bill No. 117

AN ACT Relative to the Uniform Commercial Code, and to amend Tennessee Code Annotated, Title 47.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

SECTION 1. Tennessee Code Annotated, Section 47-9-307, is amended by deleting therefrom the words "other than a person buying farm products from a person engaged in farming operations" and is amended by designating the remaining language as subsection (1) and by adding the following new subsections:

(2)(a) If any livestock subject to the lien of a security interest is sold at public auction through a public livestock market chartered in this state or through a buying station, community sale yard, or meatpacker licensed by the State of Tennessee in the ordinary course of business, a bona fide purchaser for value of such livestock shall take title thereto free and clear of any such lien, and the public livestock market, buying station, community sale yard, or meatpacker and selling agent selling such livestock shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to such public livestock market, buying station, community sale yard, or meatpacker prior to the time of the sale.

(2)(b) If any grain or soybean crop subject to the lien of a security interest is sold to any entity which is a bona fide purchaser for value and which holds a current public grain warehouse license issued by the State of Tennessee or a current federal warehouse storage license, in the ordinary course of business, such entity shall take title to such crop free and clear of any such lien, and shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the entity purchasing such crop prior to the payment of the proceeds of purchase to the owner or producer of such grain or soybean crop.

(2)(c) If any tobacco crop subject to the lien of a security interest is sold at public auction through a tobacco warehouse pursuant to Tennessee Code Annotated, Title 43, Chapter 19, in the ordinary course of business, a bona fide purchaser for value of such crop shall take title thereto free and clear of any such lien, and the warehouseman selling such tobacco crop shall not be liable to the holder of such lien, unless actual written notice as required hereinafter is given to the tobacco warehouseman prior to the payment of the proceeds of sale to the owner or producer of such tobacco crop.

(2)(d) The actual written notice required by Sections (2)(a), (b), and (c) may be satisfied when posted in the United States mail and verified by records maintained by the creditor. Said notice may be given for each individual debtor or provided in a list. The required notice must be given to the parties due same that are located in any county lying within a radius of seventy-five (75) miles of the principal office of the creditor. Such notices or lists shall be renewed annually. Said actual notice shall include the individual name of the debtor, the address of the debtor, and the proper description of the property subject to the lien and the location of the property subject to the lien as of the date the lien is perfected.

(2)(e) In the event a lien is perfected by the creditor in compliance with the procedures set forth in this section, the creditor shall not be permitted to seek recovery from a public livestock market, buying station, community sale yard, meatpacker, public grain warehouse, or tobacco warehouse unless such creditor has attempted collection by reasonable collection actions that said creditor has against the debtor-owner of said property.

SECTION 3. The State Department of Agriculture shall furnish a list of all such marketing entities to each lender whose established place of business is located within seventy-five (75) miles of such lender upon request.

SECTION 4. This act shall take effect July 1, 1983, the public welfare requiring it.

Approved, April 19, 1983

ATTACHMENT C

COMMERCIAL CODE—SECURED TRANSACTIONS—BUYER PROTECTION

CHAPTER 161

H.B.No.1106

AN ACT RELATING TO THE COMMERCIAL CODE; AMENDING 12A O.S. 1981, SECTION 9-307; PROVIDING PROTECTION TO CERTAIN BUYERS; DELETING THE EXEMPTION FOR PERSONS BUYING CERTAIN FARM PRODUCTS FROM PERSONS ENGAGED IN FARMING OPERATIONS; REQUIRING CERTAIN MERCHANTS TO OBTAIN A CERTIFICATE DISCLOSING THE NAMES OF CERTAIN LENDERS; PROVIDING FOR THE CONTENTS AND FORM OF EACH CERTIFICATE; PROVIDING PENALTIES; PROVIDING THE INSTRUMENT IN PAYMENT FOR FARM PRODUCTS TO BE MADE PAYABLE TO CERTAIN JOINT PAYEES; REQUIRING RETENTION OF THE CERTIFICATE BY THE MERCHANT; PROVIDING FOR THE LIABILITY OF THE MERCHANT; PROVIDING AN OPERATIVE DATE; AND DECLARING AN EMERGENCY.

BE IT ENACTED BY THE PEOPLE OF THE STATE OF OKLAHOMA:

SECTION 1. AMENDATORY 12A O.S. 1981, Section 9-307, is amended to read as follows:

Section 9-307. (1) A buyer in the ordinary course of business ~~(subsection (9) of Section 1-201)~~ other than a person buying ~~farm products~~ livestock from a person engaged in farming or ranching operations, hereinafter referred to as the seller for the purposes of this section, takes free of a security interest created by ~~his~~ the seller even though the security interest is perfected and even though the buyer knows of its existence.

(2) A buyer other than a buyer in the ordinary course of business ~~(subsection (1) of this section)~~ takes free of a security interest to the extent that it secures future advances made after the secured party acquires knowledge of the purchase or more than forty-five (45) days after the purchase, whichever first occurs, unless made pursuant to a commitment entered into without knowledge of the purchase and before the expiration of the forty-five-day period.

(3) (a) Before issuing an instrument in payment for farm products other than livestock, a merchant purchasing such products from a seller or a commission merchant selling such products as an agent for a seller shall require said seller to execute a certificate disclosing the names of all lenders, if any, to whom security interests have been given in such farm products. If no such security interests exist, the certificate shall so state. The certificate shall include a warning that any false statement as to the identity of the lenders is a felony and is punishable by imprisonment in the state penitentiary for a period not to exceed three (3) years or in the county jail for a period not to exceed one (1) year, or by a fine not to exceed Five Hundred Dollars ($500.00).

The certificate shall be substantially in the following form:

STATE OF _____)

) SS:

COUNTY OF _____)

The undersigned is the legal owner of the farm products being sold to (through) _____ ("Merchant") and hereby states that the following listed lender or lenders have been given a security interest(s) in such farm products:

_____

_____

_____

WARNING: ANY UNTRUE STATEMENT AS TO THE IDENTIFICATION OF SUCH LENDERS IS A FELONY UNDER OKLAHOMA LAW AND IS PUNISHABLE BY IMPRISONMENT IN THE PENITENTIARY FOR A PERIOD NOT EXCEEDING THREE (3) YEARS OR IN THE COUNTY JAIL NOT EXCEEDING ONE (1) YEAR, OR BY A FINE NOT TO EXCEED FIVE HUNDRED DOLLARS ($500.00).

This form may be witnessed by the merchant or an agent of the merchant or it must be notarized by a notary public.

SELLER: _____

Print Name: _____

Signature: _____

WITNESS: _____

Print Name: _____

Signature: _____ OR

Subscribed and sworn to before me this _____ day of _____, 19 .

_____

Notary Public

My Commission Expires:

(b) The merchant shall enter the names of the lenders disclosed in the certificate on the instrument in payment for the farm products as joint payees. The endorsement of said lenders and the seller shall be required to negotiate said instrument. The instrument shall be issued as the net purchase price for payment for the farm products.

(c) Any false statement as to the identity of the lenders shall be deemed to be a violation of Section 1834 of Title 21 of the Oklahoma Statutes.

(d) The merchant shall retain the certificate for a period of at least three (3) years. Such certificates shall be made available to such lenders during the regular business hours of such merchant.

(e) Any merchant purchasing farm products other than livestock from a seller, or selling such farm products for a fee or commission for a seller, who does not comply with the provisions of this section is liable to the secured party for any loss sustained by such party from the sale of the farm products when payment is made by the merchant to the seller. In such situation, the merchant takes the farm products subject to any perfected security interest which may exist in such farm products.

SECTION 2.[93] This act shall become operative November 1, 1983.

Approved June 6, 1983. Emergency.

93. 12A O.S.Supp.1983, § 9-307 note.

STATEMENT OF E. J. STRASMA, EXECUTIVE VICE PRESIDENT, INTERSTATE PRODUCERS LIVESTOCK ASSOCIATION, PEORIA, ILLINOIS

Interstate Producers Livestock Association headquartered in Peoria, Illinois, is one of the largest livestock marketing cooperatives in the United States handling approximately 3 million head of livestock with a gross value in excess of $580 million and servicing 35,000 farmers in the Illinois, Iowa, Missouri and Kentucky trade area. We were formed by producers that wanted a marketing organization through which they could market their livestock.

Sales of livestock in which the buyer is required to pay off a lien, and in effect, pay for livestock twice is becoming an increasing problem both in the terms of number of claims and the dollar amounts of those claims. The Illinois Farm Bureau, the largest farm organization in Illinois, passed a resolution recommending changing the Uniform Commercial Code law to provide relief to buyers of farm products.

The livestock industry is a high gross value but very low margin industry. This can be evidenced by the fact that the number of packers are dwindling and many still in existence are currently seeking wage cuts to make ends meet. Those in the marketing sector are no better off. In the best of years, profits are low and many are in a loss position currently.

The number of transactions handled in a day's time in the livestock industry is enormous. Many of IPLA's locations receive livestock from 100-200 different farmers in one day. We alone write over 15,000 checks each month for livestock. Since a lien can be put on at any time, each farmer's transaction would have to be checked out each day to discover new or changed liens. Our claim experience has shown they arise from existing customers not new customers. The livestock industry cannot afford to pay for livestock twice. It is destroying the marketing system.

The Problem

The real problem lies with Section 9-307(1) of the UCC that provides:

> A buyer in the ordinary course of business (subsections (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence.

Restated this means buyers of products in the ordinary course of business are under no obligation to search for liens but buyers of farm products in the ordinary course of business are given no protection and in fact, are specifically excluded. We

buy and make full payment just like any other buy of goods in the ordinary course of business. If anything, due to other regulations (prompt payment) and the perishable nature of the product (livestock), and the number of transactions involved, we should be the first on the list of buyers in the ordinary course of business--not the one excluded.

Livestock Prompt Payment Regulations

Section 201.43 of the regulations issued under the Packers and Stockyards Act (USDA) deals with the prompt payment of livestock.

(a) Section 201.43(b)(2)(ii) states that a check cannot be mailed for payment of livestock if the seller or his duly authorized representative is present to receive payment, at the point of transfer of possession of such livestock unless seller agrees in writing before the transaction the payment may be made by such mailing of a check. (Restated--means, if there, you have to pay immediately. We have never had a seller agree in writing to mail the check if they were present at the point of transfer.)

(b) Section 201.43(b)(2)(i) states that if a check is not given to the seller it must be mailed in an envelope with proper first class postage prepaid and properly addressed (a) before the close of the next business day following the purchase of livestock, (b) in the case of "carcass" or "grade and yield" basis, before the close of the first business day following determination of the purchase price.

Considering the number of transactions and that most of the transactions require immediate payment since the farmer is at the point of sale, it is impossible to investigate for liens--time doesn't permit. The hours of business where liens are recorded do not coincide with the hours the livestock industry has to be open. Many sales are completely consummated and paid for under the prompt payment requirements in the early morning hours (before 8:30 a.m.) and the evening hours (after 5:00 p.m.) or weekends when the lien offices are not even open.

Many counties will not give lien information over the phone but require a written request accompanied by a fee. They will process these as time permits because they are understaffed and can only handle a few requests each day--response time may take two to three weeks. Under no circumstances could they handle hundreds of requests for lien information at one time.

The lien recording places vary from State to State. However, knowing this still doesn't assure us that we will find out about a recorded lien. Some are recorded in the county where the livestock is located. The latter becomes a real problem since the farmer may have livestock in several counties. The livestock we receive out of one county may be covered by an "any and all after acquired or offspring livestock lien" in another county

hundreds of miles away. Checking the county where the livestock came from would not disclose this. At our St. Louis terminal operation, we receive livestock from several States and on some days over 50 counties.

Should we have time, personnel, and funds to check the office where a lien is recorded, we still may not know the ramifications of the lien. Many times we can't tell from the lien filing what the terms of the lien are. Does the farmer have the right to sell any or all the livestock without the lienholder's permission? Has the lien been paid off but the release not recorded? Many of the vital details would be in the underlying documents in the lienholder's office. Again this information most likely would be unavailable within the time frame of the prompt payment regulations.

Farmers have availed themselves to the various types of legal entities in operating their business--many using multiple entities. The name used in shipping us the livestock may be covered by a lien on another legal entity that would not be discovered in a lien search on the name used. No court in the land could determine true ownership within these prompt payment regulations, let alone determine lien ramifications. All other products sold in the ordinary course of business does not require title determination nor lien search.

IPLA, as a livestock company, is expected to check out up to 1,000 transactions a day for liens and determine if in fact, the livestock brought to us is really the livestock covered by a lien. The burden is on us to find the few who could ruin the financial welfare of our company.

The Lender

The lender has an automatic "co-signer" for a lien on livestock. Once the livestock is marketed, the buyer becomes a "co-signer" for someone they know nothing about.

The lenders receive compensation to assume the risk of loaning funds in the form of interest. A common argument presented by lenders is that if they have to give up the protection of the lien, the availability of credit would suffer and higher interest rates would prevail. Retailers and others who sell products in the ordinary course of business are not out of business and still obtain credit. I have yet to go into a lender's facility and see a sign advertising farm product loans cheaper than other loans. The fact a "poor risk" has to pay a higher interest rate is as it should be. The marketing chain should not have to "subsidize" a poor risk. Even farmers will tell you they don't want their marketing sources out of business because lenders made loans they shouldn't have to to the small number who are causing the problem. Farm loans will still be made but a lender will probably not loan to a poor risk and shouldn't because they are the ones destroying the marketing system, but under current law the

lien provides just enough protection to the lender to make a loan anyway.

The lenders know who their problem borrowers are. They have the loan payment records available. Yet they expect the buyers to bear the cost and liability of checking out 100% of the transactions to protect themselves against the few borrowers the lenders already know about but are under no obligation to inform anyone of problem loans. They discharged all obligations by merely filing the lien originally.

Because of the protection afforded lenders, some became lax in administering their problem loans because they know they can always come after the buyer. Many times a lender will wait years to notify a buyer of a claim which does nothing but increase the buyers liability due to multiple shipments while affording the lender time to obtain all assets possible so that when the buyer tries to go back on the borrower for the double payment, the "well" is dry. We even had one case where a banker stated to us that he hadn't even tried going after the borrower and the actual co-signer on the note because the law was such that he could get the money from us easier than from them. This was within the last year.

Lenders sometimes try to say farm products are sold "in bulk". The "bulk sales" provisions in Article 6 of the code do not cover farm products, especially livestock, as rarely is all livestock completely disposed of at one time but is marketed on a continuing basis in the ordinary course of business. Livestock producers market livestock in a systematic method maintaining a relatively constant number of animals on hand at any one time and marketing only those ready for market at any one time. In fact, hog confinement houses are set up for continuous marketing and replenishing to maintain sufficient production to keep the houses to capacity. You can hardly say this is a "bulk sale".

Qualified Audit Opinion

An auditor could ascertain that the contingent liabilities due to lien laws, their increasing number and dollar amounts, and the fact that it takes so long for a lender to notify the buyer of a claim are such that he must qualify his opinion, then the following arises:

(a) In some States, you cannot obtain a livestock or grain license if you have a qualified opinion. You are out of business.

(b) The Bank for Coops and other banks may not loan you any funds on a qualified opinion. Without borrowing power, you won't be in business long in the livestock industry.

State Legislation

More and more States are recognizing the injustices of the lien laws on farm products and are changing the Uniform Commercial Code to provide varying degrees of relief to buyers. Unfortunately there is no uniformity in their solutions.

Livestock is transported greater distances. In fact, interstate shipments are commonplace now. As stated previously, at our St. Louis terminal operation we receive livestock from several States in one day. Packers buy livestock from multiple States each day. Uniformity is needed on the Federal level because the livestock industry is truly interstate not intrastate.

The fact that more and more States are trying to do something to the Uniform Commercial Code that is becoming less and less uniform due to the multiple solutions should convince Congress that something must be done now to correct this injustice on the Federal level. Interstate commerce is responsibility of the Federal Government to regulate. This precedence is recognized by the existence of the Packers and Stockyards Act.

Some States tried centralized filing. That doesn't solve the problems of: time (unless open 24 hours a day every day), identifying true owners, incurring high costs in setting up such a system, handling the number of requests if everyone checked every transaction, ascertaining the vital details of the underlying documents, and still leaving the burden and peril on the innocent buyer to find the liens.

Some States tried lien disclosure certificates at the time of transaction. That requires thousands of pieces of paper be retained. Sometimes a seller sends a trucker in with his livestock and is not present to sign a certificate. This provides no protection to the buyer who gets a false certificate or the proceeds are not applied to the lien. Again, we are incurring enormous costs to get at the few causing the trouble.

Some States require actual notice by certified mail to buyers before a lien is valid. Once served, the notice is good until released or the statute of limitations expires. This tends to shift the burden where it should be--to the lender. Criminal penalties are usually imposed on the producer if he fails to remit the proceeds or if he sells other than to places disclosed to the lender. The buyer still shares in the responsibility, incurs additional costs, risks ascertaining true ownership and the vital details of the underlying documents. This is not working well as money leaders just send long lists of all their borrowers without identifying the type of lien--livestock, grain, etc. The lender is taking the easy way out thereby causing us to keep track of people that don't even raise livestock.

The Solution

Our recommendation is that Section 9-307(1) of the Uniform Commercial Code exempt livestock from farm products classification. This needs to be done on the Federal level for the following reasons:

1. State laws are becoming more inconsistent.

2. Livestock is marketed interstate.

3. Livestock is a very perishable product subject to shrink, disease, crippling and even death. Time is of the essence for efficient, prompt handling and shipment.

4. Livestock is sold in the ordinary course of business.

5. Lenders have consistently not acted in a prudent and timely manner under the existing law to justify the unique position they now have. To compound the problem, punitive damage claims are starting to appear in addition to actual damage.

6. The buyer should not have to share in the responsibility or assume liability (become a co-signer) just because he buys livestock in the ordinary course of business. The lender is receiving compensation for that risk and therefore should assume that risk entirely. They don't want to share anything with the buyer except the privilege of paying for livestock twice and require the buyer to bear the unnecessary costs to hopefully find those with liens when they not only know who they are but have first-hand knowledge of the problem loans.

7. The Federal Government, through the Packers and Stockyards Act and more specifically the prompt payment provisions, have singled out livestock for immediate payment with no relief from lien laws which are impossible to comply with. The system of filing liens, its related response time and the number of transactions prevent the buyer from protecting himself and yet comply with the prompt payment laws. The buyer would have to violate the prompt payment laws by a considerable amount of time under existing lien laws or even the compromises various States have passed (other than repeal) to properly protect himself.

8. Repeal is the best solution for the livestock industry and the farmers who rely on it to market their livestock through. There is no justification for lenders to hold a unique position with livestock that it does not enjoy with any other products sold in the ordinary course of business. Times and other laws have changed in the livestock industry. It's now time the lien laws comply with these changes.

Examples

Attached are some recent examples of claims along with appropriate comments.

Conclusion

The lienholder has all the facts upon which to decide whether a loan will or will not be made. They are in the position to properly supervise the payments. We should not be the "co-signer" nor should we be responsible for policing the loans. Farm products are no different than any other products sold in the ordinary course of business. The livestock industry with its regulations, sheer volume of transactions, and perishability needs relief from the lien laws. This relief should be the deletion "other than a person buying farm products from a person engaged in farming operations" in Section 9-307(1) of the UCC.

Time is of the essence as the number of claims is increasing at an alarming rate and in higher and higher amounts. Unfortunately, those happening right now won't surface for at least a year or more (as shown in the attached examples), and we predict the number will escalate even more. The livestock industry cannot survive, making double payments, when the net returns are so low.

EXAMPLE 1--Farmers Home Administration 6/25/82

Facts:

1. Livestock in question was sold 7/81 (approximately 1 year old).

2. The farmer was never told to sell his livestock.

3. The farmer went through bankruptcy in October 1981 where the debt to Farmers Home Administration was cleared in the bankruptcy.

4. In June 1982, they are trying to collect a debt that was cleared in bankruptcy from us when we didn't know of the lien, wasn't aware of the bankruptcy, and is approximately 1 year old.

UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION

June 25, 1982

Interstate Producers
Livestock Association
Griggsville, IL 62340

Gentlemen:

The Farmers Home Administration is requesting that your firm provide information on sows purchased from _____ of Versailles which were sold during 1981.

The sows were pledged as security for loans outstanding at that time.

Sincerely,

_____

EXAMPLE 2--Mr. "X"--8/18/82

Facts:

1. The livestock in question goes clear back to 7/23/79--over 3 years.

2. The details of the lien turned out to be: 34 open gilts, their offspring, all hereafter acquired gilts and sows purchased from secured party, and their offspring--filed 7/23/79.

3. A second filing was made on November 8, 1979, for 41 gilts and their offspring.

Comments: There were 46 shipments from 7/31/79 to 8/10/81 totaling $38,756.30. The lien turns out to cover only those bought from the secured party and apparently doesn't cover gilts and offspring from those not bought from the secured party. Even if we had known about the lien, how can we identify which were offspring of the gilts that were secured. There are no serial numbers on hogs. Finally, why would a prudent man allow three years to go by before contacting us about no payment. This is another example of the lienholder having nothing to lose and everything to gain by not promptly notifying us, even though his actions sanction the producer selling his hogs and not paying the lien promptly. Everyone knows you don't keep market hogs 3 years before selling them.

Dixon, Morin, Ehrmann and Gehlbach
Attorneys-at-Law
121 East First Street
Dixon, Illinois 61021

August 18, 1982

Interstate Producers Livestock Assn.
R.R.
Amboy, Illinois 61310

Dear Sir:

Our firm represents _____ of _____ Illinois. Approximately 2-1/2 years ago Mr. _____ lent some money to _____ for the purchase of some livestock. _____ admitted, during a citation to discover assets, that he had sold this livestock through your sales services. Under the law of Illinois, your firm is, therefore, guilty of converting this livestock and thus is responsible in money damages to Mr. _____.

Mr. _____ would like to resolve this matter on an amicable basis. We ask that you contact the undersigned within ten (10) days from the date of this letter so that further court costs and legal fees will not be necessarily incurred by any of the parties involved. Should you fail to contact the undersigned as requested, we shall promptly file suit to protect our client's interest.

Yours truly,

Leslie D. Lamping

EXAMPLE 3--Lien under one name--livestock shipped under another

Facts:

1. Livestock always shipped to us under Elizabeth "X".

2. In July 1981, we are notified that back in 1978, this livestock was really covered by a lien given by Dennis "X".

Comment: How can we be judged and jury on the spot to determine who really owns the livestock? Can you even imagine the legal problems let alone the practical side of challenging the ownership of livestock? No other business is required to do this in the ordinary course of business.

William G. Vogt Law Offices
Attorneys-at-Law
North Court House Square
Carrollton, Illinois 62016

July 2, 1981

Interstate Producer's Livestock Association
Pittsfield, IL 62362

Re: 1878 Purchases of Hogs Under Security Agreement to Greene County National Bank in Carrollton

Dear Sirs:

This office represents the Greene County National Bank In Carrollton, Carrollton, Illinois. We have been informed of several purchases of hogs by Interstate Producer's Livestock Association from Dennis L. Murray in early 1978, at which time said bank held a perfected security interest in all livestock on farms owned and operated by him in Pike and Calhoun counties. Enclosed are copies of the security agreements and filed financing statement in this matter.

Our information further indicates that, contrary to the provisions of the Uniform Commercial Code as enacted in Illinois and other pertinent statutes, none of the proceeds from the following purchases by Interstate Producer's Livestock Association from Dennis L. Murray were paid to Greene County National Bank In Carrollton:

Date	No. of Hogs	Price
2/8/78	34	$ 2,565.98
3/20/78	55	4,150.85
3/21/78	63	4,754.61
3/22/78	71	5,358.37
TOTAL	223	$16,829.81

We respectfully demand payment of $16,829.81 to our client as required by the aforesaid statutes.

In addition, we also request any information in your records indicating other purchases by Interstate Producer's Livestock Association from Dennis L. Murray between January 1, 1978 and June 1, 1978. If such information is not forthcoming within a reasonable period of time, appropriate proceedings will be instituted, including a subpoena duces tecum. Such a course of action would, of course, cause additional expense to all parties concerned.

If you have not already done so, we respectfully suggest you inform your attorney and your insurance carrier of this demand.

We would appreciate hearing from you concerning this matter within ten days.

Very truly yours,

William G. Vogt

EXAMPLE 4--Farmers Home Administration--Good Loan Management? Bulk Sale?

How can a lender allow a borrower to ship 27 times between February 5, 1980 and November 11, 1980 and accumulate to $88,518.10 before being concerned about payment than wait until January 14, 1982 to inform the buyer of the claim? The current system does not lend itself to good loan management if you have a built-in-co-signer.

Under no circumstances could this be called a "bulk sale". A hog producer does not go out of business 27 times in less than a year.

UNITED STATES DEPARTMENT OF AGRICULTURE
Farmers Home Administration
2106 West Springfield Ave.
Champaign, Illinois 61821

January 14, 1982

Mr. Glen Burmeister, General Mgr.
Interstate Producers Livestock Assn.
1705 W. Luthy Drive
Peoria, IL 61714

Dear Mr. Burmeister:

The attached sheet(s) list the dates of purchases, amounts paid, quantities and descriptions of swine which we understand your firm purchased from _____ of Rural Route 2, Cambridge, Illinois. That livestock is covered by a Financing Statement and Security Agreement executed by _____ which secures an indebtedness owed to the Farmers Home Administration. The Financing Statement was filed in the Recorder's office of Henry County, Illinois on July 14, 1978, as Document No. 15243.

Since the indebtedness to the Farmers Home Adminitration exceeds the value of the property purchased by you, demand is hereby made on you for payment of that value.

If you do not comply with this demand within 15 days from the date of this letter, we will recommend referral of this claim to the United States Attorney for appropriate action.

Sincerely,

Robert W. Chambers
State Director

By: James E. White
Specialist, Farmer Programs

Sales to Interstate Livestock Producers Assn.

Date	Number	Description	Amount
2/5/80	2	Boars	
	1	Sow	190.78
2/7/80	31	Barrows	
	1	Boar	
	1	Gilt	2,830.90
2/15/80	13	Sows	2,047.93
2/26/80	19	Butchers	1,705.97
3/19/80	10	Butchers	
	1	Gilt	693.87
4/10/80	2	Boars	226.40
4/28/80	16	Sows	
	2	Boars	2,127.80
4/30/80	30	Butchers	4,026.68
	89	Butchers	6,212.85
5/2/80	43	Butchers	2,819.13
5/ /80	52	Butchers	
	1	Gilt	3,708.90
5/6/80	4	Gilts	350.20
6/6/80	27	Sows	3,469.05

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cont'd

Date	Number	Description	Amount
6/6/80	112	Butchers	
	34	Sows	
	1	Boar	12,462.00
6/18/80	2	Sows	68.10
6/18/80	22	Butchers	
	11	Sows	2,958.25
6/19/80	10	Sows	1,247.22
6/26/80	12	Sows	1,541.10
7/9/80	23	Butchers	2,087.00
7/16/80	64	Sows	
	10	Boars	9,049.57
7/29/80	29	Butchers	2,756.60
7/29/80	30	Butchers	
	98	Sows	
	8	Boars	16,436.00
8/1/80	1	Boar	151.40
8/5/80	8	Sows	923.50
8/8/80	1	Sow	118.20
8/18/80	18	Butchers	
	4	Sows	
	1	Boar	2,789.05
8/22/80	1	Boar	191.90
11/11/80	32	Sows	
	6	Butchers	5,327.75
		TOTAL	$88,518.10

STATEMENT OF GRANVILE TILGHMAN, CHAIRMAN, COUNTRY ELEVATOR COMMITTEE OF THE NATIONAL GRAIN AND FEED ASSOCIATION, WASHINGTON, DC

Mr. Chairman and Members of the Subcommittee:

My name is Granville Tilghman. I am President of General Utility Company, a country elevator in Dunn, North Carolina. I am Chairman of the Country Elevator Committee of the National Grain and Feed Association, which I represent in my appearance today.

The National Grain and Feed Association is a voluntary association of grain and feed firms ranging in size from the smallest country elevator to the largest grain and feed complex, and includes merchandisers, processors, warehousemen and exporters of a wide spectrum of grains and feeds. Its membership includes 1,300 direct memberships by individual firms and 44 state or regional grain and feed associations affiliated with the National Association that include membership upwards of 10,000 grain and feed firms nationwide.

I am pleased to have the opportunity to testify on the problems caused by the purchase of mortgaged agricultural commodities. As you are well aware, during the last few years this problem has been the subject of many hearings before state legislatures across the U.S. We commend the chairman and members of this subcommittee for providing this forum to give national attention to this problem and to seek industry input toward feasible and reasonable solutions.

The Problem for Grain Buyers

Section 9-307 of the Uniform Commercial Code (UCC), adopted by most of the states, provides: "A buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence." (emphasis added). The so-called "farm products exception" of the UCC, treats agricultural producers differently than all other businessmen. Unlike any other business transaction, this means that a purchaser of grain or livestock from a producer is liable to the secured lender in the event that the producer fails to pay his debt.

The problem with this exception for agricultural commodities that confronts grain buyers is two-fold: 1) The grain buyer is faced with the risk of substantial loss if the producer defaults on his loan, and 2) The grain buyer must invest time and administrative expense in searching county clerks' offices for the existence of liens on agricultural commodities he intends to purchase.

Concerning the extent of risk of financial loss, we are not aware of any data that shows the total amount of losses grain

buyers in the U.S. have incurred in recent years. But reported losses by some individual grain elevators demonstrate the potential catastrophic consequences of the grain buyer's liability to the lender. In 1982, nine elevators in the state of Ohio reported total losses of $204,000 for an average loss of more than $22,000 per facility. Indiana had one case in which an elevator lost $125,000 to a farm lender. In Illinois, one elevator reported a single loss of $57,000 in 1981, and currently there are three cases in Illinois courts each of which could result in a loss exceeding $100,000 to individual companies.

These examples of losses that have occurred are offered to demonstrate that a single loss can be financially devastating to a small company.

In addition, there is evidence that the risk to grain buyers is increasing rapidly. Because of the low farm income situation in many regions, producers are relying on lenders to finance growing crops more than before. Based upon a survey conducted by the Kansas Grain and Feed Dealer's Association, an estimated 51 percent of the grain purchased in Kansas in 1982 and 1983 was mortgaged. This compares with 42 percent in 1981. Also, as farms have grown in size, the amount of potential loss has grown increasingly large. Another problem contributing to the size of loss is that in many states, liens that are filed in the county clerk's office may remain effective for as long as five years. Thus, if the producer fails to repay loans, the grain buyer may be liable for purchases over a period of several years.

The second problem with mortgaged agricultural commodities under the UCC of most states is the burden it places on grain buyers to conduct lien searches. Typically, after a producer obtains a loan, the lender files a lien form on growing crops with the county clerk's office in order to "perfect" his security interest. The lien is filed in either the county of the debtor's residence or in the county where the crops are grown. When the crop is harvested and delivered to the elevator, the grain elevator must attempt to determine whether there are any existing security interests before purchasing the commodity.

In most states, that involves checking with local lenders to determine if a lien has been filed on a farmer's crop. Under the best of circumstances, this is a laborious, time-consuming and expensive process. One elevator operator estimated his company's manpower and administrative costs for lien searches at $25,000 a year.

Lien searches also delay payment by the elevator to producers. If lenders do not assist grain elevator operators or the grain elevator believes information collected directly from lenders does not adequately protect his interests, the only alternative is to make a detailed search of all recorded security interests. Because a single farmer's operations may span over several counties, a search must be completed in every county where the

farmer has growing crops. As the percentage of farmers requiring additional financing has grown, the time and expense to elevators in completing lien searches also has increased. The process of searching county files is a very inefficient means of collecting lien information. Even if such checks are made, there is no ironclad guarantee that an existing lien will be discovered.

State Legislation

There have been a variety of legislative proposals in various grain producing states to alleviate the problem of buying mortgaged grain. As of September 1984, a total of 15 grain producing states have enacted legislation amending the UCC to address this problem. Of states making such a change, five (Illinois, Indiana, Michigan, Kentucky and Ohio) have enacted legislation requiring lenders to notify grain buyers by registered or certified mail about the existence of liens filed on commodities. Failure of the lending institution to so notify grain buyers relieves the buyer of responsibility.

Successful passage of amending legislation in 15 states and serious consideration of legislation in other states is indicative of the urgency with which needed changes are being sought.

However, from a national viewpoint, the National Association has concerns as to how individual state actions may affect the uniformity of state laws. As states develop individual approaches to solving the problem of mortgaged farm commodities, we no longer have a UCC that is uniform across all states. Differences in applicable commercial law among the states presents an obstruction to free-flowing trade and orderly marketing.

The National's Position

The National Grain and Feed Association in July surveyed three of its operating committees to determine their views on the mortgaged grain issue. The views of the three committees surveyed--Country Elevator; Terminal Operations and Marketing; and Feed Industry--were conveyed to the National Association's Board of Directors.

At its meeting on Sept. 11-12, the Board of Directors after a thorough discussion of the issue formulated and adopted the following position to address the mortgaged commodities problem:

"It is the position of the National Grain and Feed Association that Congress should enact federal preemptive legislation requiring that any farmer who executes a mortgage on grain or livestock notify the mortgage holder of the names and addresses of other persons to whom he will market those products. The mortgage holder, if he wishes to have a joint check drawn, shall be required to notify the potential buyers by certified mail of the existence of the lien. Failure of the mortgage holder to so notify shall release the buyer from liability.

Criminal penalties shall be assessed against a producer who sells to a buyer other than those specified in advance to the mortgage holder in the event the loan is not repaid."

The National Grain and Feed Association believes this approach offers the most equitable solution for buyers, lenders and producers of agriculture commodities for the following reasons:

-- It relieves the buyer of agricultural commodities from the burden, expense, time and risk involved in conducting lien searches county-by-county.

-- It resolves the most critical problem involved in mortgaged commodities by providing information to the buyer of those commodities on which a lien may exist and relieving the buyer of liability in the event the lender fails to notify potential buyers of the existence of the lien.

-- It recognizes that the country elevators and feed manufacturers frequently are placed in the role of lender when financing producer's crops, farm supplies, feed and livestock. It provides equity to those needing some limited security provided by liens issued for feed, fertilizer and other farm supplies.

-- It is more feasible to implement than a national central filing system, as there are substantial "start-up" costs and delays associated with central filing.

-- As federal preemptive legislation, it would establish nationwide law that would apply to federal lending agencies, such as the Farmers Home Administration and the Farm Credit Administration.

-- Although it is federal preemptive legislation, its enactment would result in minimal disruption of the laws of existing states that have adopted a similar legislative approach (Illinois, Indiana, Kentucky, Michigan and Ohio).

-- It provides the most feasible solution because of the initial record of success of similar legislative approaches in several states.

-- Finally, it is a fair solution to the problem of mortgaged commodities. Under the current UCC in most states, lenders have no responsibility once liens are perfected. This situation is not conducive to sound lending practices. The National Grain and Feed Association's position is fair to all parties involved--the producer, the banker and the commodity buyer--and recognizes that each legitimately should share the responsibility. Under the National Grain and Feed Association's position, the producer is responsible for providing accurate information on potential buyers to his lender. The lender is responsible for notifying

buyers. And, once notified, the buyer is responsible for ensuring that payments on commodities are properly drafted to all parties having ownership or security interests.

In summary, the present treatment of farm commodities in the UCC is based upon the conditions and structure of agriculture that existed in the early 1950s when the UCC was first drafted. U.S. agriculture has changed dramatically since that period. The farmer of the 1980s is a commercial businessman, and the law should reflect that reality. The agricultural commodity buyer should not be burdened with sole responsibility for policing the security interests of lenders. Nor should lenders bear the entire risk of default on mortgaged commodities.

In seeking a permanent and equitable solution, producers, lenders and commodity buyer each must share part of the responsibility. The National Grain and Feed Association believes federal preemptive legislation to require prior notification of liens obtained on agricultural commodities and livestock balances the needs of all parties in commercial transactions of mortgaged commodities, and we urge Congress to act on our proposal.

STATEMENT OF NORBERT E. BRANDT, GENERAL MANAGER, MIDWEST LIVESTOCK PRODUCERS COOPERATIVE, FRANCIS CREEK, WISCONSIN

Honorable Members:

I would like to submit a statement for the record on the hearing held September 26 before the Senate Subcommittee on Agricultural Research and General Legislation.

The Company I represent is Midwest Livestock Producers Cooperative located at Francis Creek, Wisconsin. Midwest Livestock Producers is a livestock marketing agency which markets all species of livestock. Livestock is sold throughout the United States and to several foreign countries. Last year our sales amounted to 105 million dollars. The net earnings after taxes amounted to $140,496. While this is a very small ratio of earnings to sales, the performance is still above average for the livestock marketing industry.

I point this out because Midwest Livestock Producers presently has $278,954 in claims filed against us for supposedly purchasing mortgage livestock. During the past three months $32,466.85 was paid on claims. This does not include any attorney fees or "in company" expense and time.

The majority of claims filed against Midwest are for supposedly purchasing cull dairy cows where liens existed. These cows are usually consigned at the rate of one or two head at a time. Many

of these are hauled to market by a local trucker so employees of Midwest do not have any direct contact with the consignor.

It is financially and physically impossible for us to check out all the consignments to see if there are liens on the livestock. In Wisconsin most of our county Register of Deeds Offices will not provide this information over the phone. Those that do have a charge that represents a very high percentage of the commission earned from the sale. We also have a large number of night sales and Saturday night sales where the offices are not open.

As a livestock marketing agency governed by the United States Packers and Stockyards Division we must pay the consignor within 24 hours of the sale. We do not quarrel with this but point out the fact that we do not have the time to again check out any liens. Midwest Livestock Producers presently received $6.75 per head to market slaughter cattle. For this we must provide all the services, guarantee payment and worry about the collection of our money. Then we must also guarantee the loans from the lending institutions. As a result, we are asked to pay twice for these cattle.

The entire farm community needs a change in the present laws. Hard working, honest, aggressive, intelligent farmers are being financially harmed by the small minority who operate in poor faith and unbusinesslike manner. Livestock marketing agencies have two options. One is to greatly increase our commission to cover these losses and the other option is to discontinue business. If the latter becomes the avenue then I wonder who will represent the producer in the market place.

STATEMENT OF NANCY PATTON, PRESIDENT,
PATTON COTTON COMPANY, LUBBOCK, TEXAS

Mr. Chairman, I am Nancy Patton of Patton Cotton Company, Lubbock, Texas. Patton Cotton Company was founded in 1977 by my father, Henry Patton who started in the cotton business in 1948. Upon his retirement in 1982 I took over the business which handles approximately 50,000 bales of cotton produced in Texas and Oklahoma.

As a small business employing three people we find it extremely cumbersome to function in an active cotton market on the High Plains of Texas when we are required to constantly search lien records in order to protect ourselves from making a second payment on the cotton when the farmer has defaulted on his bank loan. We also find ourselves facing substantial risks in the normal course of business because of the inequity written into the UCC to protect lenders. Patton Cotton Company now faces such a situation even though we paid the farmer $14,600 and the farmer deposited the money in his account at the lending bank.

On January 13, 1983, Oasis Gin in Seminole, Texas called my firm and offered several lists of cotton. Later that same day, a representative from the gin notified us that we had bought some of the lists we had bid on and they instructed us on how to make payment. On one particular list, we were directed to make payment to Cecil M. Hatch. Mr. Hatch was going to be in Lubbock the following morning and could bring us the warehouse receipts and pick up his payment. This was in the usual course of business. We checked the Farmers Home Administration list to be sure there was no FmHA lien on the cotton. There was not. We attempted to call the county clerk's office for Gaines County, but were informed that they were unable to give out lien information on the telephone. We would either have to drive to Seminole to the county clerk's office or correspond through writing. Neither of these choices was satisfactory in order for us to continue to do business in an efficient and normal manner. We can not afford to have someone check all county clerk's offices in person for every list of cotton we buy. Nor can we afford the delays caused by doing a lien search through the mail.

On January 17, 1983, Mr. Hatch deposited the check we issued into his farm account at Brownfield State Bank and Trust Company, Brownfield, Texas. The check was made out to Cecil M. Hatch and notation on the check indicated it was for payment of seventy (70) bales of cotton. Over the next month, Mr. Hatch wrote checks on his farm account paying normal farm expenses. Prior to January 1983 Cecil M. Hatch had signed a security agreement with Brownfield State Bank and Trust Company pledging everything he owned, had owned, and wanted to own. In March, he filed bankruptcy. In May of 1983 Patton Cotton Company received a demand letter from Brownfield State Bank's attorney for payment of the seventy bales. We refused to pay for this cotton again, therefore Brownfield State Bank and Trust filed suit in 237th District Court of Lubbock, Texas.

Within the last six months, Brownfield State Bank and Trust Company has been taken over by the FDIC due to a bad loan portfolio. Therefore, the FDIC now owns the litigation and has transferred the venue to federal court.

So now we have one bankrupt farmer and one bankrupt bank. Thanks to this cumbersome bureaucratic system of ours, we may have a bankrupt cotton merchant to add to the list.

98TH CONGRESS
1ST SESSION

S. 2190

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 18 (legislative day, NOVEMBER 14), 1983

Mr. HUDDLESTON introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

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A BILL

To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers of farm products.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) title XI of the Agriculture and Food Act of 1981 is amended by adding at the end thereof a new section 1123 as follows:

"PROTECTION OF BUYERS OF FARM PRODUCTS

"SEC. 1123. Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the

seller even though the security interest is prefected and even though the buyer knows of its existence.".

(b) This section shall become effective thirty days after enactment, except that liens made prior to the effective date shall be exempt from the provisions of this section.

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D C 20250

AUG 28 1984

Honorable Jesse Helms
Chairman, Committee on Agriculture,
Nutrition, and Forestry
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

This is in reply to your request of November 30, 1983, for a report on S. 2190, a bill "To amend the Agriculture and Food Act of 1981 to provide protection for agricultural purchasers on farm products."

This Department opposes enactment of the bill.

The bill would provide that "Notwithstanding any provision of Federal, State, or local law, a buyer in the ordinary course of business who buys farm products from a seller engaged in farming operations shall take free of a security interest created by the seller even though the security interest is perfected and even though the buyer knows of its existence."

This proposed bill would eliminate the right of an agricultural lender to recover its loan security after the security is converted by a buyer.

The commerce of farm products, including livestock, between the farm and market often involves informal, unregulated and unverifiable transactions. Such transactions are unique to farming and create unusually high risks for agricultural lenders. Section 9-307 of the Uniform Commercial Code (UCC) attempts to balance the high risk associated with agricultural lending with the inherent advantage enjoyed by the buyers of farm products. The proposal embodied in S. 2190 is in direct conflict with existing provisions of the UCC in most States.

In the judgement of the Department, which conducts substantial agricultural lending operations through the Farmers Home Administration, S. 2190 would increase our losses and other lenders' losses on loans. As proposed S. 2190 would result in lenders being less willing to lend for the production and purchase of farm products and would raise the cost of agricultural credit and restrict its availability. Further, the elimination of the agricultural lender's right to recover security would remove an existing deterrent that discourages the unchecked and uncontrolled conversion of security by buyers.

We understand the pressures and the problems buyers of farm products face but they are in a much better position to protect themselves than are lenders. The UCC requires lenders to file a notice of their security interest in the public records as prerequisite for perfecting liens on farm products. In addition, some States' UCC now require that agricultural lenders provide buyers of farm products with lists of their farm loan customers in which lenders claim security interests in farm products.

Some States have already made, and other States are considering, revisions to their UCC that do not impose the financial burdens on lenders and farmers that S. 2190 would create.

Consequently, we believe that Federal legislation such as S. 2190 is inappropriate and unnecessary at this time and would be economically harmful to the entire agricultural industry.

The Office of Management and Budget advises that there is no objection to the presentation of this report from the standpoint of the Administration's program.

Sincerely,

John R Block

John R. Block
Secretary

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